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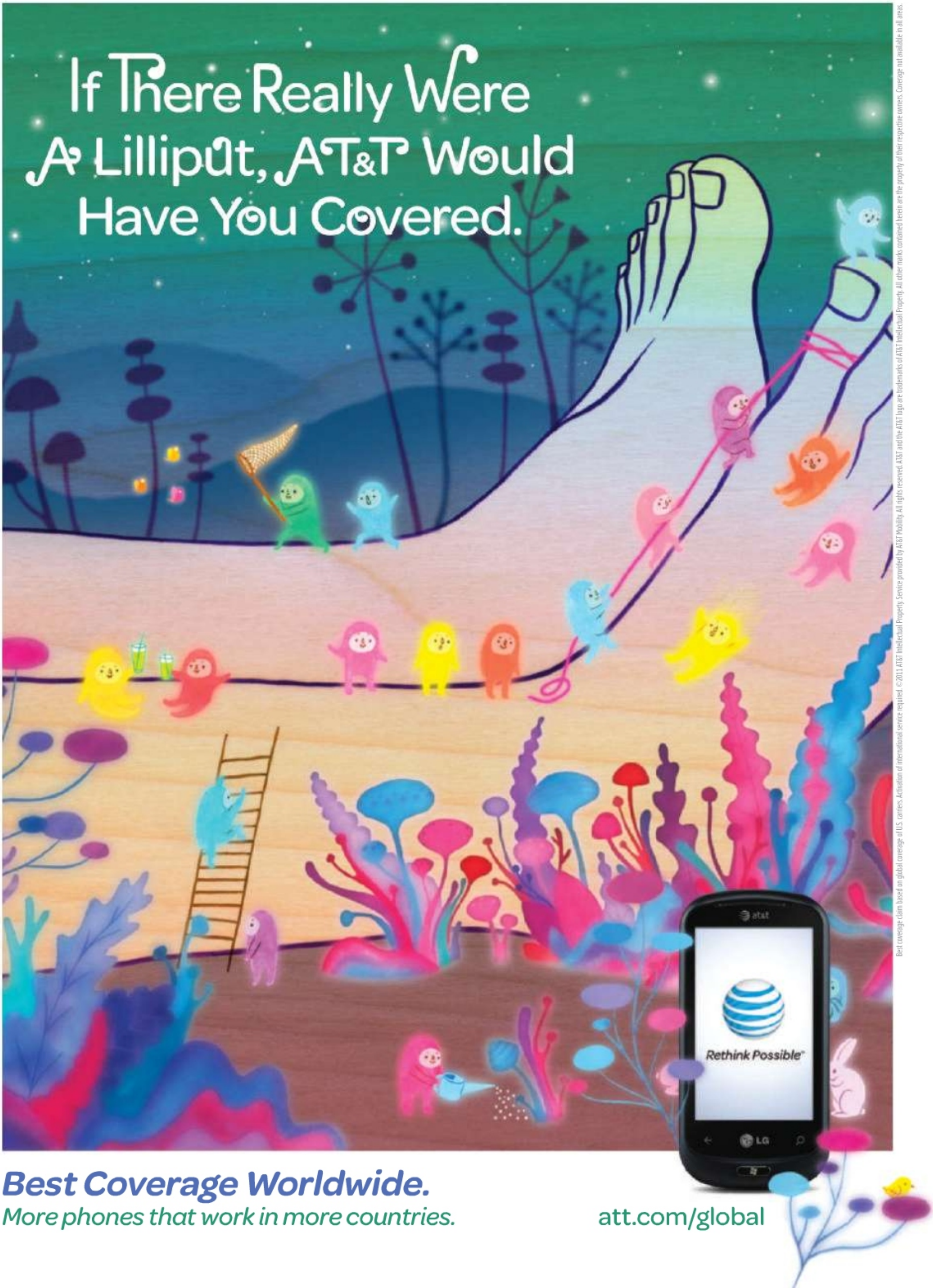
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Corrections & Clarifications

"A Trade Deal's Long And Winding Road" (Politics & Policy, Dec. 13) should have said trade between the U.S. and South Korea, and not just U.S. exports to South Korea, total $68 billion a year. In the Dec. 13 Hard Choices, we mistakenly put the value of capital raised to accelerate growth at Commerce Bank as 1 million pounds. The correct amount is 51 million pounds.

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Opening Remarks



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The Health-Care Act on Trial

The health-care insurance mandate isn't a ploy to expand Congress' power. It's a way to address unique problems
By Peter Coy

A jagged line running north-south through the map of Virginia separates the state's Eastern and Western federal judicial districts. As 2010 wound down, that boundary came to symbolize a deep philosophical split over whether an activist, ambitious government is good or bad.

At stake is the 2010 act that extends health insurance for the first time to almost all Americans, rich and poor alike. On Nov. 30 a federal district judge in the Western District who was appointed by President Bill Clinton, Norman K. Moon, supported the Obama Administration by upholding the constitutionality of the act. On Dec. 13, scanning the same facts in a different case, Judge Henry E. Hudson of the Eastern District, who was appointed by President George W. Bush, ruled the Patient Protection and Affordable Care Act unconstitutional. Hudson said its requirement that people must buy health insurance if they can afford it was an "unchecked expansion" of congressional authority that "would invite unbridled exercise of federal police powers."

Hudson's strong language has the flavor of the Supreme Court decisions of the 1930s, when the high court frustrated President Franklin D. Roosevelt by nixing key elements of the New Deal. For the Obama Administration, the risk is that the Supreme Court, already moving rightward under conservative Chief Justice John G. Roberts, will see things Hudson's way when the case he heard, or a similar one, reaches the high court on appeal. If the Roberts Court seizes on this case to lay down a sweeping precedent limiting congressional power, it will be a blow not only to universal health care but also to a wide range of other government initiatives.

Opting out of health insurance is a decision to throw oneself on the mercy of the emergency room

Can the Obama Administration save the health-care act? Yes, but not by relying solely on familiar legal arguments.

In *Sebelius v. Virginia*, the case that came before Hudson, the government contended that Congress can impose an insurance mandate under 1) its constitutional authority to regulate interstate commerce, and 2) its power to pass any law "necessary and proper" to carry out its enumerated powers. That didn't impress Hudson, and there's no certain-

"The individual mandate is absolutely key." Amitabh Chandra, economist, Harvard University

ty that it will sway Justice Anthony M. Kennedy, the Supreme Court's swing voter in many close decisions. In 1995, Kennedy concurred with the majority in *United States v. Lopez*, a guns-in-schools case in which the high court for the first time since the New Deal put limits on Congress's application of the Constitution's commerce clause (page 28).

To win the legal battle—as well as the battle for public opinion—the Obama Administration must address directly the qualms about overreaching that Hudson expressed in his opinion. The way to do that is to make a persuasive case that mandatory coverage is not the first step on a slippery slope to totalitarianism.

The best case against the slippery slope argument isn't even a legal one. It's in an amicus curiae brief filed in November in a broader Florida case by 41 top economists, including three Nobel laureates, Kenneth Arrow of Stanford, Eric Maskin of Princeton, and George Akerlof of Berkeley. They argue that health care has unique characteristics that justify the congressional mandate—and since other markets such as food and housing don't have those characteristics, Congress will never have any justification to intervene in them to the same degree.

The economists' argument bears attention. Arrow, 90 years old, has been probing the peculiarities of the health sector since 1963, when he wrote a much-cited paper, "Uncertainty and the Welfare Economics of Medical Care," that's mentioned in the brief. Arrow and the other economists say—in agreement with the Obama Administration—that a health insurance system that must accept all comers but can't require everyone to join will quickly enter a death spiral. Healthy people won't opt in until they need coverage, so many or most of the insured will be sick and costly. As a result, insurers will have to raise rates, pushing the last few healthy customers out, forcing rates on the rest to go even higher, and so on until it leads to collapse. Amitabh Chandra, an economist at Harvard University's John F. Kennedy School of Government who joined the amicus brief, writes in an e-mail: "We don't let people buy car insurance after they've wrecked their cars, or after we find their house is on fire. For the same reason, the individual mandate is absolutely key."

No other market has all the characteristics of health care. Customers don't know exactly what they need or sometimes how to obtain it; their decisions affect others (for example, skipping treatment could spread disease); competition is limited. Medical care is unavoidable, expensive, and can't ethically be denied. Costs of care are routinely shifted onto people or institutions with deeper pockets.

Judge Hudson in his ruling stresses that the health-care law attempts to regulate commercial "inactivity," i.e. not buying insurance. He argues that this makes the law more intrusive than laws governing commercial "activity" that the Supreme Court has upheld in the past. To the economists, though, it's a phony distinction: Opting out of insurance isn't inactivity—it's a decision to throw oneself on the mercy of the hospital emergency room or taxpayers. Take it from Mitt Romney, the Republican who as Massachusetts governor signed a law similar to Obama's health-care act and whom the economists quote. "A free ride on the government is not libertarian," Romney said while signing the act into law in 2006.

Practical-minded health-care executives and lawmakers are already studying how to save the 2010 health-care act if the coverage mandate—which takes effect in 2014—is struck down by the courts. Dan Mendelson, chief executive officer of Avalere Health, a Washington-based consulting firm, says one option might be to provide access to all people, even ones with pre-existing conditions, but to limit the times they could sign up. The idea is to induce them to carry insurance even when they don't need it, knowing they won't be able to jump into a plan the moment they're sick. "It's using a carrot instead of a stick," Mendelson said in a telephone interview before the ruling.

Private health insurers already have the kind of sign-up windows that Mendelson mentions. In Germany, some private insurers also set health-insurance premiums the way life insurance is often priced. The premiums are higher than is actuarially fair in the early years of a policy and lower than actuarially fair in the later years, giving people an incentive to stick with a policy once they sign up for it.

The "windows" approach is no panacea. Uninsured people who miss the sign-up window and get sick will be out of the system and stuck in the same mess they're in today. And while pricing premiums the German way might retain insurance customers, it won't get them in the door in the first place. Mark J. Browne, a professor of risk management and insurance at the University of Wisconsin-Madison who has studied the German system, concludes that the U.S. law can't work without a coverage mandate. "My personal belief is that it's absolutely, critically important," Browne says.

The health-care act has split the nation as thoroughly as the line that separates Virginia's Eastern and Western judicial districts. Nineteen states have signed on to Florida's challenge of the act. Yet the mandate is necessary if Obama's health-care plan is to succeed. The onus is on the Administration to show why the mandate is both constitutional and beneficial, and why it won't send the nation down a slippery slope to autocracy. If the Administration succeeds in doing so, the healing of the health-care rupture can begin.

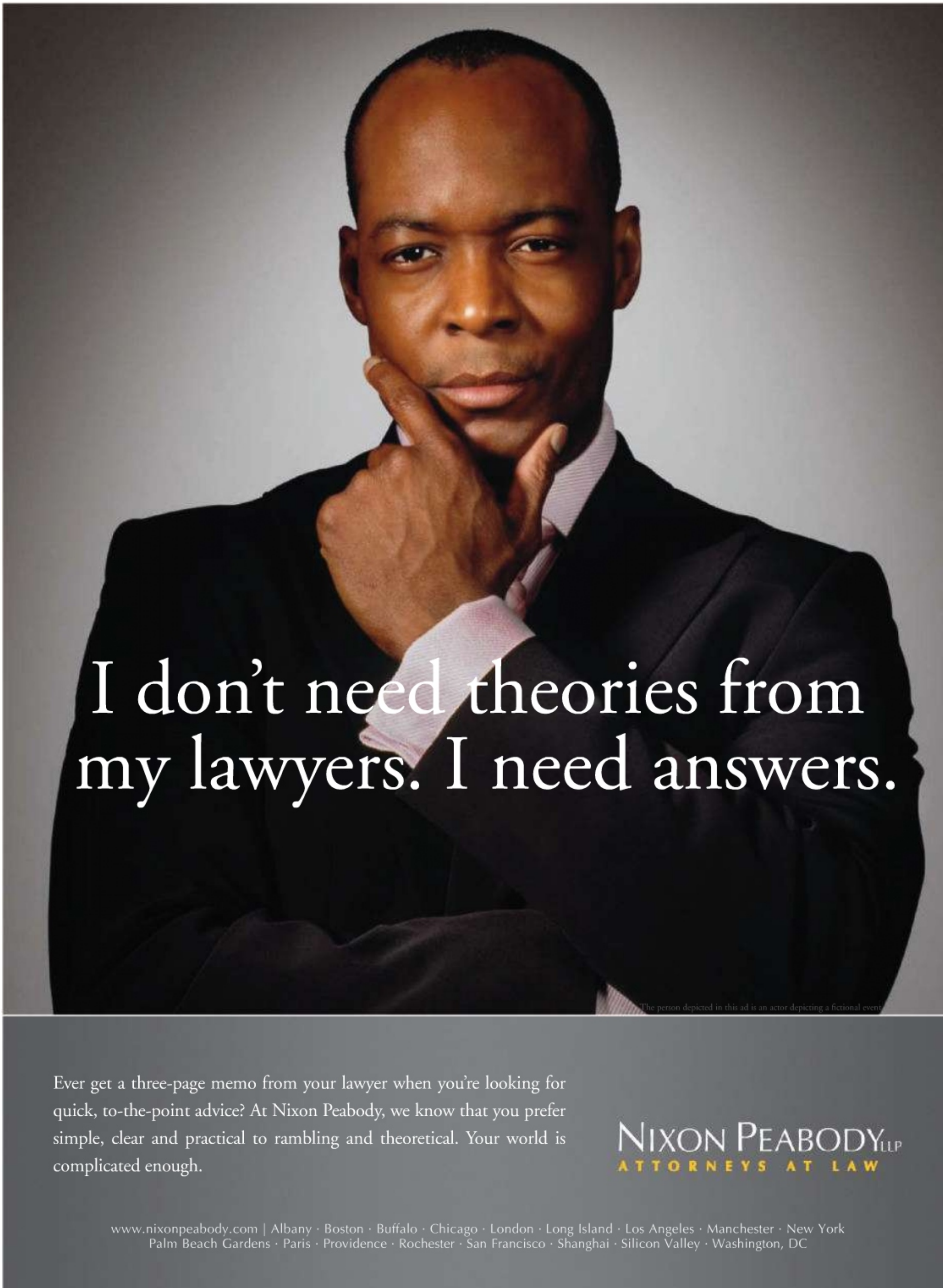
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Global Economics



For the U.S., the Future Suddenly Feels Brighter

▶ Taxes stay low, money floods the market, animal spirits revive

▶ "Unintentionally, QE2 is leading to a fragmentation of markets"

ISTOCKPHOTO

The battle to extend the Bush-era tax cuts was politically divisive, and the process agonizingly prolonged. Yet the decision to continue the cuts—and throw in a few others—is already producing something the U.S. economy needs: optimism. While U.S. growth has accelerated in recent months, the tax deal, signed into law in December, has suddenly made economists, consumers, and companies such as **General Electric** more confident about 2011. "That deal was measurably better than I had anticipated," says Mark Zandi, chief economist for Moody's Analytics. "I feel sentiment shifting. It feels like business is ready to turn the light switch on."

The change in sentiment is all the more striking when compared with the rest of the world. Europe is stuck in its sovereign-debt morass, while China, India, and other emerging countries struggle to cap a rise in inflation. "The new, new, new normal is for the U.S. to be looking in pretty good shape," says Jim O'Neill, the London-based chairman of Goldman Sachs Asset Management. It's "raising issues about the whole allocation of capital between so-called emerging markets and the U.S.," says O'Neill, who popularized investing in emerging markets by coining the BRIC moniker for Brazil, Russia, India, and China.

Goldman Sachs has lifted its 2011 forecast for the U.S. economy to 3.4 percent from 2 percent

The Standard & Poor's 500-stock index of U.S. stocks was up 12.8 percent for the year as of Dec. 28, vs. declines in emerging markets such as China and Brazil. It also exceeded the gains in the MSCI World Index, which tracks developed-nation equities. U.S. chief executives polled in the fourth quarter by the Business Roundtable were the most optimistic they've been

Global Economics

in almost five years. Jeffrey R. Immelt, chief executive officer of GE, called President Barack Obama's tax cut and his Dec. 15 meeting with corporate leaders "real positives." Executives were pleasantly surprised that the budget deal included a temporary decrease in payroll taxes and a tax break for business investment.

Even long-time bears are getting more upbeat. **Goldman Sachs** chief U.S. economist Jan Hatzius has lifted his 2011 forecast to 3.4 percent from 2 percent to take account of the fiscal agreement and a spate of stronger-than-expected economic statistics.

Mohamed A. El-Erian, chief executive officer of **Pimco** in Newport Beach, Calif., says the stimulus should help the U.S. expand by 3 percent to 3.5 percent in the fourth quarter of 2011 year over year. El-Erian previously predicted growth of 2 percent to 2.5 percent.

Yet there are limits to how much fiscal and monetary stimulus can achieve, El-Erian cautions. He points to the rise in long-term interest rates since Obama unveiled his $858 billion tax-cut compromise with Republicans, a sign that bond buyers, long unconcerned about the U.S. deficit, may be starting to worry. The yield on the Treasury's 10-year note was 3.48 percent on Dec. 28, according to Bloomberg data, compared with 2.92 percent on Dec. 6, the day the alternative tax deal was announced.

The outlook for 2011 is taking shape as many governments and central banks shift away from the united approach of easier fiscal and monetary policies they had used to tackle the recession and its aftermath and begin to work more in their own self-interest. In the U.S., for example, the Federal Reserve has embarked on its second round of so-called quantitative easing (QE) with a plan to buy $600 billion of long-term Treasury securities through June.

The Fed's actions are designed to make credit more available in the U.S. and stoke a recovery. Yet a chunk of that money will end up invested in emerging markets, which are struggling already to absorb billions in foreign capital, contain inflation, and keep their currencies competitive. The reluctance of China and other emerging-market economies to rein in growth too much is boosting demand for commodities and jacking up the cost of energy worldwide, including in the U.S. "Unintentionally, QE2 is leading to a fragmentation of global financial markets, because each country takes actions to protect itself," Nobel laureate Joseph E. Stiglitz, an economics professor at Columbia University, said at a seminar in Santiago, Chile, on Dec. 10.

November's 5.1 percent annual gain in China's consumer prices was the largest since July 2008, and people there are more concerned about rising costs than at any time in the past decade, according to the People's Bank of China, the country's central bank. The PBOC raised benchmark interest rates for the second time in three months on Dec. 26, to 5.81 percent for loans and 2.75 percent for deposits. Prices in Brazil rose by 0.83 percent in November from the prior month, the most since April 2005.

In the U.S., sustaining the economic momentum is the priority for now, not tamping down inflation. "Policymakers are going to keep on running into each other," says Stephen King, chief economist at HSBC Holdings in London and a former U.K. Treasury official. The result will be a "very uneasy, very uncertain" world. —*Rich Miller and Simon Kennedy*

The bottom line *While the U.S. economy may prove surprisingly strong in 2011, the cost of that growth could be increased friction with other countries.*

Predictions 2011

No. 1

What will hiring be like in 2011?

"The focus for 2011 will be on the jobs that are pivotal to driving growth."
—Ravin Jesuthasan, global practice leader for talent management at consulting firm Towers Watson. He predicts that by the end of 2011 the unemployment rate for professional and related occupations, just 4.1 percent in November 2010, will probably fall below 4 percent as companies accelerate growth through product development and market expansion.



14



Public Health

In India, a Spike In Oral Cancer Rates

▶ **Mass-marketed chewing tobacco makes it easy to acquire the habit**

▶ **"I have seen many... who started when they were 8 or 10 years old"**

Safiq Shaikh was 13 when he began chewing a blend of tobacco and spices that jolted him awake whenever his job at a textile loom got too dreary. Five years later, doctors in Mumbai lopped off his tongue to halt the cancer spreading through his mouth.

Shaikh believed the fragrant, granular mixture he chewed, known in India as *gutka*, was harmless, so at first he ignored the milky lump growing inside his mouth. Now he is one of about 200,000 Indians diagnosed with a tobacco-related malignancy this year, says his surgeon, Dr. Pankaj Chaturvedi, who works at Tata Memorial Hospital in Mumbai.

Chaturvedi says a group of entrepreneurs known as "*gutka* barons" bear

CLOCKWISE FROM TOP: PRASHANTH VISHWANATHAN/ BLOOMBERG(2); KUNI TAKAHASHI/BLOOMBERG



A Mumbai merchant sells *gutka* as well as areca nut mouth freshener at a stall

This hand-rolled *paan* contains fennel seeds, dates, areca, and sugary flavorings. Tobacco can be added





Oral cancer has spiked in India as more Indians chew tobacco and use other tobacco products

much of the blame for this epidemic by mass marketing a mix of tobacco and areca nut for 1 rupee (2¢) a pack on street corners across India. Sales of chewing tobacco in India, worth 210.3 billion rupees ($4.6 billion) in 2004, are on track to double by 2014, according to Datamonitor, the international research firm. Before, a traditional chewing mixture, known as *paan*, came with or without tobacco. It had to be handmade, was messy to carry around, and lacked modern packaging. “Now you have an industrial version of a traditional thing” spurring demand, says Chaturvedi.

On Dec. 7, India’s Supreme Court banned the sale of tobacco products in plastic wrappers as of Mar. 1, citing harm to public health and environmental damage from improper disposal

“*Gutka* barons” sell the tobacco mix for 2¢ a pack. The market could reach $9 billion in size by 2014

of the packets. The ban on the cheap, colorful packaging was aimed directly at the *gutka* merchants. Yet the sale of *gutka* remains legal, and marketers may switch to other packaging.

Gutka creates a tingling sensation on the tongue. It’s the abrasion of the mouth’s lining—caused by coarse chunks of areca nut—that can accelerate the effect of nicotine and cancer-causing chemicals, according to Dhirendra Sinha, a technical officer for tobacco control at the New Delhi office of the World Health Organization (WHO).

Street vendors of *gutka* crowd around schools, breaking Indian law, which prohibits the sale of tobacco products within 100 yards of educational institutions, says Devika Chadha, a program director at the Salaam Bombay Foundation, a nonprofit that works with schools to educate children about tobacco’s dangers. “I have seen many children who started chewing *gutka* when they were 8 or 10 years old and got cancer in their teens,” Chaturvedi says as patients with tubes protruding from their throats wait their turn outside his office.

While Indian law bans the consumption of tobacco products before the age of 18, enforcement of the law is spotty, says Chadha. The federal government says it’s up to the states to enforce these laws, and often the states lack the resources. According to the Press Trust of India, the Indian news service, a minister in the Maharashtra state government, which includes Mumbai, said on Dec. 24 that school principals will be given authority to fine *gutka* vendors who set up stalls within 100 meters of their school.

In Khetwadi, a poor Mumbai neighborhood, three street vendors on a recent morning set up stalls about 55 yards from Sant Gadge Maharaj College as students gathered near the school gates. Javeed Shaikh, 21,(no relation to Safiq Shaikh) says he began chewing *gutka* three years ago and now consumes two or three packets a day. “I’m trying to quit, and it’s hard,” he says.

Rajendra Malu, who owns the company that makes the Jhee brand of *gutka*, says a pouch contains three-fourths areca nut and 12 percent tobacco flakes, as well as proprietary fragrances he won’t disclose. A chemical analysis of *gutka* in a 2008 report from the WHO found that a typical mix contains chromium, nickel, arsenic,

lead, and tobacco-related nitrosamines, all known carcinogens.

Malu estimates he sold 250 million packets last year made at his plant in Gujarat state. He shrugs at the mention of a link between *gutka* and cancer. "I have been chewing tobacco for the last 37 years, and I am not suffering from anything," he says. On being asked about children's consumption of *gutka*, he replies, "This is not a fact."

A survey of 1,500 Mumbai residents aged 13 to 15 found that double the students identified themselves as tobacco chewers vs. a decade ago, according to Healis, a public health research institute. In accordance with the law, packages of *gutka* bear a health warning and the image of a scorpion to indicate its use has been linked to cancer. That's not effective, says Jagdish Kaur, chief medical officer at the tobacco control unit of the Ministry of Health & Family Welfare. While the government has just mandated a new set of warning labels on tobacco products to show graphic images of mouth cancer, the industry has gotten a one-year delay in publishing them.

Gutka brings on cancer much faster than its traditional handmade counterpart, says Saman Warnakulasuriya, a professor of oral medicine at King's College London. The tobacco releases nitrosamines while the chemicals in areca nut stimulate the production of collagen, a protein that thickens the mouth's muscles. Abrasions from the areca expose the blood vessels in the mouth, a trauma that can take several hours to heal, according to Chaturvedi. "This injury and healing process is going on for 24 hours," he says: Over time it stiffens the inner lining of the mouth, resulting in a precancerous condition called oral submucous fibrosis. Once a a disease of the elderly, it is now spreading to young Indians, according to a government report.

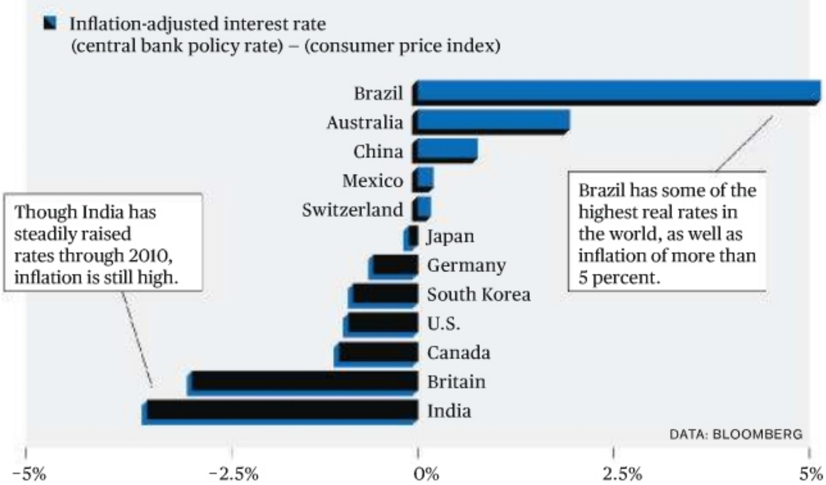
Patients who previously could grab a sizable chunk of an apple in a single bite are eventually able to open their mouth to just about the size of a grape. "Before I could put four fingers inside, now I can only put two," says Aqeel Shaikh, 32, Safiq's older brother. Shaikh says he chewed six packets of *gutka* a day for six years before he gave up the habit. —*Adi Narayan*

The bottom line *A mass-produced chewing tobacco in India that is popular among teenagers is triggering a surge in mouth cancers.*

Cost of Money

With Inflation-Adjusted Rates, Central Banks Are Giving Money Away

Although inflation is low in much of the world, inflation-adjusted rates are often lower. In times of sluggish borrowing, central banks often make money essentially free by keeping rates below inflation or just a few notches above.



Municipal Crises

Bankruptcy: For Cities, There Are Downsides



▶ Vallejo's Chapter 9 saga scares municipalities into cutting costs

▶ "It's best to negotiate your way out of the problem"

By Jan. 18 the city of Vallejo, Calif., must submit a bankruptcy-exit plan to a Sacramento court. The plan will outline how the municipal government will meet $195 million of unfunded pension obligations, trim employee benefits, delay payments to bondholders, and set aside money for unsecured creditors.

If the court approves the plan, the city of 120,000 will be one step closer to the end of a painful experiment in restoring Vallejo's finances. When Vallejo filed for Chapter 9 bankruptcy protection in May 2008 after failing to win pay cuts from the city workers' unions, Vice-Mayor and Councilwoman Stephanie Gomes said officials around the U.S. would have their eyes trained on the city, which sits 32 miles north of San Francisco.

The lesson other cities have drawn from the two-year-old case, which has cost Vallejo $9.5 million in legal fees and made it a nationwide symbol of distressed municipal finances, is that out-of-court negotiations yield better results. "They spent a lot of money with very little outcome," says Jay M. Goldstone, San Diego's chief operating officer, who relied on negotiated pay cuts and higher benefit contributions from the unions to resolve his city's fiscal crisis in 2009.

"A lot of cities looked at Vallejo and concluded that painful as it might be, there must be a better solution than to pay millions in legal fees and give control of their city to the bankruptcy court," says Paul Rosenstiel, California's deputy treasurer from 2007 to 2009 and now a principal with municipal-bond under-

FROM LEFT: CHIP CHIPMAN/BLOOMBERG; ANDREW HARRER/BLOOMBERG

AstraZeneca's risky R&D bet page 20 ▶

writer De La Rosa in San Francisco.

Five municipal entities sought protection in 2010 compared with 10 in 2009, according to data compiled by James E. Spiotto, head of the bankruptcy practice at Chapman & Cutler, a Chicago law firm. Harrisburg, the Pennsylvania state capital, weighed a Chapter 9 filing in 2010 after it couldn't make $282 million of payments on bonds. The situation prompted Pennsylvania Governor Edward G. Rendell to advance $3.3 million to the city on Sept. 13. "We couldn't stand by and let the city default," Rendell said at the time, arguing that a default could raise borrowing costs elsewhere in the state. Hamtramck, Mich., which has lost funds over a disputed revenue-sharing agreement with Detroit, wants to file for bankruptcy, says City Manager Bill Cooper. The state Treasury Dept. says the city has to follow a complex procedure laid down by state law before its application can be considered.

Vallejo had no other options but to file, says Marc A. Levinson, a partner with the San Francisco-based law firm Orrick, Herrington & Sutcliffe who is drafting Vallejo's bankruptcy-exit plan. "We couldn't get the concessions from the unions and from the bondholders that would keep us out of bankruptcy," says Levinson, who works out of Sacramento. The city has since reached agreements with administrative and police unions that yielded $6 million in savings through June 2010, its website says. The firefighters union agreed to a new contract that was approved by the council in March.

The bankruptcy process could take another six months, further distracting local officials, says Christopher J. Mier, chief municipal bond strategist with Loop Capital Markets in Chicago. City residents have 159 fewer fire and police personnel than seven years ago, road maintenance is at 10 percent of recommended levels, and grants for arts and cultural programs have been eliminated. Gomes, the council member, sums it up: "It's best to negotiate your way out of the fiscal problem before you go into bankruptcy."

—*Alison Vekshin and Martin Z. Braun*

The bottom line *Though U.S. cities face serious financial difficulties, seeking a solution through bankruptcy is proving costly and prolonged.*

Predictions 2011

No. 2

What's the big challenge facing China?

"To avoid the fate of Japan. China is facing a situation very similar to that of Japan in the 1980s. We are seeing asset inflation, particularly in real estate. There is a reluctance to shift from an export-driven to a consumption-driven model. Everyone says in China that has to happen. But in this year when that adjustment should have happened, we haven't seen it."

—Patrick Chovanec, associate professor at Tsinghua University's School of Economics and Management



Consumer Debt

Canadians Spend Like Crazy Americans

▶ **Household debt in Canada edges past the U.S. level**

▶ **"The Bank of Canada is in a bit of a box, given where the Fed is"**

Spendthrift Canada? Many Americans would find that hard to believe. Throughout the subprime crisis that rocked the U.S., Canada's economy and banking industry remained rock solid.

Yet in mid-December, the Canadian government released statistics showing that the indebtedness of Canadians surpassed U.S. levels for the first time in 12 years. Household debt as a portion of disposable income was 148 percent in the third quarter, according to government agency Statistics Canada, exceeding the U.S. level of 147 percent.

Canadians, it turns out, have been acquiring big mortgages, too, as the country's recent prosperity drove demand for bigger and better housing. Low interest rates have encouraged Canadian consumers to take on debt, while banks, largely untouched by the financial crisis,

Tom Keene's EconoChat

Tom talks with Oppenheimer & Co. managing director **Fadel Gheit** on oil, speculators, and the price of gasoline.

Why are we at $91 a barrel?
No. 1, hope for economic recovery is underway. A lot of people are more optimistic now. No. 2, the stock market is at its highest level since August 2008, and oil prices go hand in hand with stock prices. Third, there's a lot of speculation. The same people who brought us that 2008 oil price collapse are coming at it again. And I think we're going to take oil prices higher.

So $100 a barrel is pretty much a foregone conclusion?
I wouldn't say foregone conclusion, but it is not out of the question either.

What about beyond $100 a barrel?
Once you break into the triple digits, it becomes pure speculation because I don't believe that a commodity that is very profitable from $65 on should be trading at a 50 or 60 percent premium. Once you see gasoline prices creeping up, people will take notice and oil prices will moderate.

There's this idea that oil demand has been off the mark in developed nations. Will demand revert to the trend that we saw pre-crisis?
Demand will continue to rise in the emerging economies, and will continue to flatten or even decline in the advanced economies. Yet both developing and developed countries are working very hard to improve efficiency. So we are likely to see global demand for oil increase, albeit at a much lower rate than was the case in the last five years or so. **B**



Keene hosts Bloomberg Surveillance *7-10 a.m., 1130AM in New York, XM 129, Sirius 130.*

Global Economics

have continued to lend. The average size of a mortgage in Canada has gone from C$120,000 in 2004 to $170,000 as of last spring, according to CIBC World Markets, a Canadian investment house.

The rise in household debt puts the government and central bank in a corner. The ordinary response is to cool borrowing off by raising interest rates. Bank of Canada Governor Mark J. Carney has boosted the benchmark rate three times since June to 1 percent.

The problem is that further rate hikes increase the cost of servicing mortgages, which stretch debt-laden households. Higher rates would also attract foreign investors looking for higher-yielding bonds. That would strengthen the loonie further: It's basically at parity with the greenback, which has weakened against most currencies in the last year as the Federal Reserve pursued a loose monetary policy.

A stronger Canadian dollar would make exports pricier—especially to the U.S., Canada's biggest trading partner—and put growth at risk. "The Bank of Canada is in a bit of a box, given where the Fed is and where the Canadian dollar is," says Douglas Porter, deputy chief economist with BMO Capital Markets in Toronto.

Finance Minister James M. Flaherty is trying to cool the market off, too. The government has tightened rules on refinancing and down payments, and made it harder to qualify for government-insured mortgages. "Everybody knows, I think, interest rates will have to go up over time," Flaherty says. "So people have to make sure they can afford their mortgage payments when interest rates rise."

The central bank will have to weigh all these issues before its next interest rate announcement on Jan. 18. While in December it kept rates steady, the pressure to raise them and slow down consumer borrowing is increasing. "The level of vulnerabilities of households remains high," Bank of Canada's Carney said at a press conference on Dec. 13. "Without a significant change in behavior, the proportion of households susceptible to serious financial stress will continue to grow." Ⓑ

—*Theophilos Argitis and Greg Quinn*

The bottom line: *Canada's residents have so much household debt that officials are trying to slow their borrowing without strengthening its dollar.*

Seven Days

Events of note in the week ahead

by Ira Boudway

03

Orange Bowl: Stanford vs. Virginia Tech in Miami



▶ **Eviction moratorium ends:** Freddie Mac's 15-day suspension of evictions expires for homes that hold mortgages from the agency.

04

Fed releases minutes of FOMC meeting on Dec. 14

Germany's unemployment rate for December

▶ **Tax bump in Britain:** The U.K.'s value-added tax—charged on business-to-business transactions—rises from 17.5 percent to 20 percent. A study by KMPG says that retailers plan to pass the increased cost on to consumers.

05

112th U.S. Congress convenes

Japan's vehicle sales for December



▶ **2011 International CES:** Microsoft's Steve Ballmer delivers a pre-show keynote address for the four-day Consumer Electronics Assn.'s show (Jan. 6-9) in Las Vegas.

06

Monsanto earnings



▶ **Economists in Denver:** The annual meeting of the Allied Social Science Associations includes speakers Simon Johnson, Esther Duflo, and Federal Reserve Vice-Chair **Janet Yellen**.

07

Germany's trade balance for November

U.S. consumer credit for November



▶ **U.S. unemployment:** Surveyed economists anticipate a slight decline from the current 9.8 percent rate.

08

NBA: Boston Celtics vs. Chicago Bulls



▶ **Sydney Festival:** The Australian city's annual two-week summer celebration begins. Performers include **Sufjan Stevens**, **Emmylou Harris**, and **John Malkovich** in *The Giacomo Variations*.

09

Walt Disney World Marathon at the theme park in Orlando

▶ **Referendum in Sudan:** The country's South is expected to vote in favor of independence from the North. The U.S. hopes to broker a deal over possession of the central oil-rich region of Abyei.

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worldmags

Companies&Industries

AstraZeneca's Risky Bet On Drug Discovery



▶ Forgoing acquisitions and diversification, the pharma giant looks for new pills in its own labs

▶ "This is the path we've chosen. Only history is going to be able to judge if we were correct"

During a meal of beef and potatoes at **AstraZeneca**'s drug research center near Stockholm in October, Chief Executive Officer David Brennan grilled six drug development managers over a concern raised by a laboratory scientist. During a town hall meeting that morning, the newly recruited researcher had told Brennan he didn't have the freedom to pursue unusual ideas that he would have in academia, and Brennan wanted to know why, according to one research manager who was questioned by the boss. Brennan has more reason than most drug company CEOs to want his scientists to be happy and productive. While competitors such as **GlaxoSmithKline** and **Sanofi-Aventis** expand into flea sprays and energy drinks to offset slowing drug revenue, AstraZeneca is sticking to one business: developing pharmaceuticals innovative enough to command premium prices.

Betting on drug discovery is risky. The industry has gone through a dry spell: All of the current 15 best-selling drugs won approval at least six years ago, according to data compiled by IMS Health and Bloomberg. More than half of London-based AstraZeneca's $32.8 billion in sales came from drugs that may face generic competition by 2014. The company has been one of the worst performers among big drugmakers in winning approval of medicines in the U.S. or the European Union in the past three years, according to statistics compiled by rival **Novartis**. "We're going to figure out how to get through this," says Brennan, a former college linebacker. "People are living longer and getting older, and they are consuming more health care. They want advances."

Investors are skeptical. AstraZeneca's shares trade at about 7.1 times estimated earnings, the cheapest of the world's big drug companies. Switzerland's **Roche Holding**, which gets about 20 percent of sales from disease-detecting tests, and **Johnson & Johnson**, which derives almost two-thirds of revenue from medical devices and consumer products, are more highly valued in part because of their diversification beyond the feast-or-famine drug business. "The market seems to be saying essentially that R&D productivity [at AstraZeneca] is dead, that they're destroying value by investing in research and development," says Gareth Powell, who helps run $200 million in health-care funds at Polar Capital Partners in London.

Brennan's commitment to research stems from his time at **Merck**, when the U.S. drugmaker dominated global drug discovery and blockbusters were easier to find. He joined Merck as a 21-year-old salesman in 1975 and was there when the company's labs pioneered new ways to treat hypertension and cholesterol. "This is what David saw happening," says P. Roy Vagelos, who ran Merck's R&D and later, when he became CEO, promoted Brennan to run its new collaboration with Swedish drugmaker Astra. "That apparently has influenced his view of running a pharma company, which I think is a correct view," says

ILLUSTRATIONS BY JENNIFER DANIEL; BLOOMBERG(3)

Generic competition looms for big sellers such as Nexium, Seroquel, and Crestor

CEO Brennan is counting on R&D



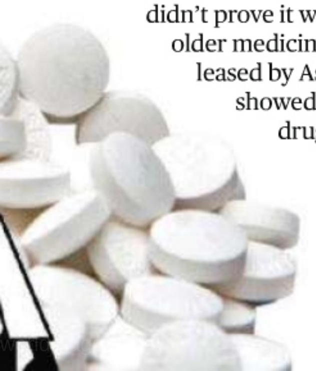
Vagelos, 81. "The world has changed, but the impact of important new drugs that fulfill unmet medical needs is no different now than it was then."

While researchers today understand diseases better because of breakthroughs in genetics, drugmakers are having limited success translating those advances into major new medicines for heart disease, pain, or cancer. Regulators also are requiring more safety measures after several big-selling drugs proved more dangerous than anticipated, and governments, especially in Europe, and insurers in the U.S. are pushing back on price hikes.

Despite these headwinds, Brennan's commitment to R&D as the road to growth is making AstraZeneca a magnet in the research community. Looking for someone to invigorate his labs, Brennan in May recruited Menelas Pangalos as head of early-stage drug research. Pangalos previously helped build the industry-leading portfolio of experimental drugs at Wyeth, which **Pfizer** bought in 2009 for $68 billion, largely because of those drugs. "As the head of research, you want to be hearing your CEO say that the way we are going to grow the business is by driving successful research and development," says Pangalos. "It's an incredible challenge." Brennan also poached Pfizer's global research chief, Martin Mackay, for AstraZeneca's most senior R&D role, president of research and development.

Brennan has reviewed every step in the development process, has narrowed the scope of research to focus on more promising areas such as diabetes and cancer, and has shut some sites to save $1 billion annually by 2014.

To succeed, Brennan will have to fix an R&D operation stung by failures. In December, the company dropped development of motavizumab for infant respiratory disease, taking a $445 million charge, after a U.S. advisory panel recommended against approval because studies linked it to allergic reactions and didn't prove it worked better than older medicines. Trial results released by AstraZeneca in May showed the experimental drug Recentin didn't improve prospects for colon cancer patients. And in June the U.S.



AstraZeneca remains committed to developing new drugs despite some expensive failures

Food and Drug Administration failed to approve Axanum for ulcers. These follow four potential blockbuster cardiovascular or diabetes drugs that failed in late-stage trials from 2006 to 2008.

AstraZeneca did win permission in December to sell Brilinta, the company's most important experimental product, in the EU. The clot-preventing drug proved more effective in studies than Sanofi-Aventis' and **Bristol-Myers Squibb**'s Plavix, which had $9.8 billion in sales in 2009. Still, the FDA declined to approve the drug on Dec. 17, saying it wanted additional analysis of a study that compared the two drugs.

Like its competitors, AstraZeneca is experimenting with new ways to organize research to improve productivity. Scientists now are responsible for candidate drugs until they begin the final human trials, ending a culture of handing off early-stage products to other researchers as if on an assembly line, Brennan says. He's also willing to license experimental compounds from other companies. "We need to change the way we're doing it because we haven't been successful," Brennan says.

AstraZeneca's focus on pharmaceuticals puts additional pressure on the company, according to Andrew Baum, a Morgan Stanley analyst in London. "When you have an enormous patent cliff, poor record of returns in R&D, no diversification, what do you do?" asks Baum. "It's not a strategy of choice. It's a strategy that was thrust upon them."

Brennan wants investors to focus on dividends and buybacks while revenue "fluctuates" until 2014. The company expects revenue of $28 billion to $34 billion annually through 2014 as it loses patent protection on its two biggest-selling drugs, heartburn treatment Nexium and anti-psychotic Seroquel. Brennan has gotten additional time to make his plan work. On June 29 a U.S. judge ruled that the patent on AstraZeneca's Crestor cholesterol drug is valid until 2016. The decision safeguarded $2 billion in U.S. sales. The company plans to submit the diabetes drug dapagliflozin for approval in the U.S. and Europe by early 2011. AstraZeneca may get a decision from the FDA by Jan. 7 on vandetanib, a treatment for advanced cases of a rare thyroid cancer.

Brennan has convinced AstraZeneca's board that the company should stick to the business of developing pharmaceuticals, says Jane E. Henney, one of the directors who chose him as Tom McKillop's successor in 2005. "I don't sense there's any feeling among the board that we should move in another direction," says Henney, a former FDA commissioner. "It's the path that we've chosen. Only history is going to be able to judge if we were correct."

—Trista Kelley and Michelle Fay Cortez

The bottom line *While other big drugmakers are diversifying beyond pharmaceuticals, AstraZeneca is sticking with risky in-house drug development.*

Medical Products

Can Health Care Cure Cleveland's Ills?

▶ **To boost jobs, the Ohio city bets on a medical products expo center**

▶ **"I'd want to see some commitments before I spend that kind of money"**

Cleveland, which has been losing manufacturing jobs for decades, has spent almost $1 billion on everything from new downtown sports stadiums to the Rock and Roll Hall of Fame in an attempt to rev up its economy, so far with mixed success. Next up: health care. In January construction will start on a $465 million Medical Mart & Convention Center targeted at manufacturers of health-care equipment and supplies.

Besides offering space to showcase and market high-tech medical equipment, project backers hope visitors will also want to see new gear in action at the nearby **Cleveland Clinic**, one of the country's top medical centers. The broader aim: to rebrand Cleveland as a health-care hub that will attract well-paying industry jobs to the region. "High-tech medical, biotech, that's going to be the new face of the community," says Timothy F. Hagan, a Cuyahoga County commissioner who championed the project.

To get there, the county is



Farmer Filburn and the future of health care page 28 ▶

teaming with a unit of **Vornado Realty Trust** to redevelop the space underneath the 14-acre Cleveland Mall, a public square overlooking Lake Erie. Under the terms of the deal, the public would pay the entire $465 million construction budget and subsidize Vornado's operating expenses. The planned 422,000-square-foot exhibition center will be funded mainly with a quarter-cent sales tax increase.

All told, taxpayers may put as much as $840 million into the development, including debt costs over 20 years, says Tim Offtermatt, senior vice-president at Stifel Nicolaus, the investment bank managing a county bond offering for the project. Vornado is contributing $28.5 million, Offtermatt says. It also is responsible for cost, repair, and operating overruns, he says.

Whether the new concept will pay off in jobs and revenue is uncertain, says Tom Murphy, a senior resident fellow at the Urban Land Institute. The Medical Mart has yet to sign any permanent tenants. "It's a shot in the dark in some ways, in their ability to create a new diversity for their economy," says Murphy, who was mayor of Pittsburgh from 1994 through 2005. "I would want to see some commitments before I would spend that kind of money."

Backers of the mart say it suits the area's changing job mix. Since 2000, Cuyahoga County has lost 41 percent of its manufacturing jobs, a total now down to 68,500 in 2009. Meanwhile, employment in health care and social assistance increased 19 percent, to 118,000.

The Medical Mart is the brainchild of Delos M. "Toby" Cosgrove, chief executive officer of Cleveland Clinic, a sprawling health-care complex east of downtown that ranked fourth this year on *U.S. News & World Report*'s list of top U.S. hospitals. The medical center is the largest nongovernment employer in northern Ohio and the second-biggest in the state, with about 40,000 workers. "In order to build a hospital, I wound up traveling all over the country and the world to see various pieces of equipment," says Cosgrove. "It would be nice to have all those things in one place."

These aren't rich times for the exhibition and trade show industry, which slumped along with the economy in 2008 and 2009, according to the Center for Exhibition Industry Research. Revenue dropped 16 percent last year. Medical and health-care shows fared better: Revenue increased 1 percent.

Cleveland's Medical Mart also faces competition. Market Center Management, the trade show arm of **Crow Holdings**, is building its own health-care showcase in Nashville, which is scheduled to break ground in 2011. That project will have about 10 times the 100,000 square feet of permanent showroom space for medical products planned for Cleveland, says Market Center Management CEO Bill Winsor. And unlike the Cleveland project, the Nashville Medical Trade Center has an announced tenant, **Healthcare Information and Management Systems**, a nonprofit that promotes information technology for medical providers.

Although mart backers say they've received 40 letters of intent from potential lessees of exhibit space, they haven't disclosed the names of prospects. Cleveland Clinic's Cosgrove downplays the project's risks. "What's the worst thing that could happen if this fails?" he asks. "You have a brand-new building and a new convention center. So the downside isn't too bad." —*David M. Levitt*

***The bottom line** Cleveland hopes to draw visitors and tech jobs by building a medical exposition center. The cost and competition make the plan risky.*

Predictions 2011

No. 3

What unexpected challenges face airlines in the coming year?

"The single biggest issue facing the airline industry, and by extension [all] aerospace, is fuel. It's sheer cost, but it also comes in the form of the climate-change debate—the threat to the industry of imposing taxes, or cap-and-trade, or whatever. There is an imperative for the industry to become more climate-friendly—if not for economic reasons, then for social responsibility issues."
—Gary Kelly, CEO, Southwest Airlines





CLOCKWISE FROM TOP: COURTESY MARY LOU SPURGEON; WENG LEI/IMAGINECHINA/AP PHOTO; STEPHEN HILGER/BLOOMBERG

Cosmetics

Selling Skin Cream to China's 'City Jade Men'

▶ L'Oréal, Shiseido, and others target China's new metrosexuals

▶ Using "this stuff, you get the confidence you need for the day"

Every morning, Shane Zhang uses a facial scrub and applies a toner from **Estée Lauder** and a **L'Oréal** moisturizer. At night he uses **Lancôme** anti-aging cream. Twice a month he treats himself to a La Cure facial using mud from the Dead Sea. "People say I look younger than my age," says the 28-year-old, an advertising salesman for lifestyle magazine *Men's Uno* in Shanghai who spends about 1,000 yuan ($150) a month on cosmetics. "Since I'm a salesperson, it definitely helps."

Daily rituals such as Zhang's have prompted cosmetics giants including L'Oréal, Nivea maker **Beiersdorf**, Japan's **Shiseido**, and a slew of domestic entrants to target men in China. Sales of men's health and beauty merchan-



The men's skin-care aisle at a supermarket in Shanghai

dise in China are set to overtake those in North America this year and will probably grow about five times faster until 2014, according to data from researcher Euromonitor International. "All the major cosmetics companies are focusing on this segment," says Lynn Zhou, a retail analyst with brokerage CLSA in Shanghai, who says sales of men's products in China are growing at more than double the pace for women's.

Rising incomes, growing popularity of magazines such as the Chinese editions of *Esquire* and *GQ*, and the desire to find a competitive edge at work are driving demand for men's skin-care products. Men who use cosmetics are called *du shi yu nan*—literally, "City Jade Men," a moniker akin to "metrosexuals" in the West. "Chinese men are now more concerned with appearances and projecting an image of success," says Shaun Rein, managing director of Shanghai-based China Market Research Group. "First they were spending on watches and pens and shoes as a status symbol, then five years ago they were focusing more on apparel, and in the last three years there is a real upsurge in male cosmetics."

29%

Annual growth forecast for men's skin-care product sales in China

Spending by Chinese men on face creams, anti-aging gels, and cleansing lotions already exceeds spending on razors and blades by more than 30 percent, and the gap will keep widening, says **Procter & Gamble**, which has created a brand called Olay For Men sold in China. The Chinese men's skin-care market may reach $270 million this year, vs. $227 million for North America, according to Euromonitor. The research company expects annual growth of 29 percent through 2014, compared with 5.7 percent for North America and 7.9 percent in Europe. "In the U.S. or Mediterranean countries, when we tried to tell men to use cosmetics they would say, 'Come on. I'm a man, and creams are for girls,' " says Jean-Michel Ripoll, L'Oréal's Shanghai-based general manager for market research. "In China we don't have to fight against that."

Liang Guang, a 29-year-old architect for a property company in Beijing, began buying cosmetics after seeing a television commercial for L'Oréal men's products featuring Hong Kong action star Daniel Wu. "I think men and women are equal in terms of making themselves look good," Liang says while dropping $42 for a bottle of Shiseido Men's Moisturizing Emulsion at a department store. "Every morning when you wake up and use this stuff, you get the confidence you need for the day."

L'Oréal is China's No. 1 men's skin-care brand with about 32 percent of the market in 2009, driven by sales of Biotherm Homme and L'Oréal Men Expert, China's top-selling men's cosmetic brand, according to Euromonitor. China's **Shanghai Jahwa United** holds the No. 2 slot in men's skin care with its gf line—the name sounds like the Chinese word for golf—which it says uses ingredients from desert plants that protect the skin. Shiseido, which began selling its Aupres JS brand in 2001 and introduced the Shiseido Men line in 2005, is fourth after Beiersdorf.

L'Oréal in 2008 introduced its Vichy line in China, and late last year started selling Garnier, a brand aimed at entry-level cosmetics users, espe-

Speed Dial Sylvia Ann Hewlett

The founder of the Center for Work-Life Policy talks about the group's new report, *The Battle for Female Talent in India*

How serious is India's talent war? The economy is growing 8 to 9 percent a year. But the constraint is talent. By 2012 there could be 5 million fewer highly skilled people than needed. Recruiting and keeping talented people is a big issue for companies, and educated women are not being fully utilized. There is an unexpected reality for managers, too: The public sector is very appealing for women. Those jobs are prestigious, the salaries are good, and the workweek is not as extreme.

Are women prepared to compete? Forty-two percent of graduates are female, and 80 percent of working women describe themselves as very ambitious. That doesn't diminish as they get older. Those figures are staggering. In America, by age 40, there's a real drop in ambition among women.

What's keeping those ambitious women out of the workforce? There is a diffuse set of cultural pressures. One surprise: Women in India don't expect to be sidelined by motherhood. Women have extended family support, and there is low-cost domestic help. Elder care is more problematic. There is a great tradition of filial piety. The traditional role of a woman in the extended family still tends to create pressures to quit for a while.

Can businesses really help? Companies such as Ernst & Young are organizing family days where women bring in their husbands, parents, and in-laws to get briefed on opportunities they have. More challenging is mobility; working somewhere else means shifting the entire extended family. [So] Goldman Sachs and Citibank offer short-term assignments. —*Susan Berfield*

cially those in smaller cities away from the prosperous coastal regions. Women account for about half of purchases, bought as gifts for husbands and boyfriends, says Paolo Gasparini, L'Oréal's China chief executive officer. "This surprised me, for I am Italian, and Latins are more macho and only use products they buy for themselves," Gasparini says. "Chinese men don't have any problem using products bought for them by women." *—Frederik Balfour with Michael Wei*

The bottom line *Chinese men are buying and using skin-care products in greater numbers than men in the U.S. and Europe.*

Brewing

Modelo, Long Engaged, Wants to Stay Single



▶ **The Mexican brewer is chafing under its partnership with AB InBev**

▶ **"The environment is getting tougher because things are consolidating"**

While some global brewers are aggregations of local beers that are each strong in their home markets, Mexico's **Grupo Modelo** is the owner of a true cross-border success story: Corona. The pale lager's foreign appeal has helped shift more than 40 percent of Modelo's sales to markets outside Mexico. And Modelo managers believe there's more growth ahead if they can continue expanding their brews internationally. "What the controlling families–the Mexican families–want today is to keep working to consolidate and strengthen our company," says Chairman and Chief Executive Officer Carlos Fernandez Gonzalez, whose uncle married the sister of one of the founders.

Executing that go-it-alone strategy will be tough. Acquisitive Belgian brewer **Anheuser-Busch InBev**, the world's largest, inherited a 50 percent stake in Modelo plus 9 of its 19 board seats through its $52 billion acquisition of the former Anheuser-Busch in 2008. In July, Modelo lost an arbitration bid to deny board seats to some AB InBev directors. Moreover, the beer industry's global consolidation has left Goliaths such as AB InBev, **SABMiller**, and **Heineken** so big that it's increasingly difficult for independents such as Modelo to develop the distribution and marketing muscle to compete.

In gaining the Modelo stake held by the U.S. brewer, AB InBev also inherited long-running tensions between the partners. Anheuser-Busch in 1993 agreed to buy 10 percent of the Mexican brewer, with options for more; the stake has since grown fivefold. After the 1994 peso devaluation, however, Modelo and Anheuser-Busch sparred over how to value options to buy more of the Mexican company. Modelo continued its expansion in the U.S. without using Anheuser's distribution network. Competition from Corona later led Anheuser to create Bud Lime as a counterpart to its ambitious partner's flagship.

Since Anheuser-Busch's change in ownership, the frosty relations continue. Modelo greeted the AB InBev takeover with a $2.5 billion legal challenge, claiming it violated the original option agreement with Anheuser-Busch, and the Mexican brewer attempted to block the transfer of its shares to the Belgian beer giant. Two months ago, Modelo chose an AB InBev rival, **Molson Coors Brewing**, as a distributor of its brands in Britain. Modelo has been "very protective" of its independence, notes David Belaunde, a Barclays Bank analyst in New York.

Fernandez says Modelo isn't looking for acquisitions and won't add other beverages to diversify beyond beer. Further expansion in Mexico is limited by Modelo's 58 percent local market share as well as inroads there by Heineken, which last year paid $7.6 billion for the beer business of **Fomento Económico Mexicano**. Given that environment, exports will remain Modelo's lifeblood, Fernandez says. "This is the unique business model that we have," he explains.

Although Modelo's legal challenge has been turned back, management still isn't making nice. As Fernandez last month toured a new $650 million brewery in the northern city of Piedras Negras with reporters in tow, he noted that Modelo is starting a relationship with "partners that we don't know." The plant is part of an effort to boost exports to the U.S., where Modelo has been No. 1 by volume among imports since dethroning Heineken in 1997. AB InBev so far has had nothing but accolades for its new beer buddy. It has "great respect" for Modelo, its brands, and senior management and looks forward to continuing the partnership, says Karen Couck, a spokeswoman for the Leuven (Belgium)-based company.

43%

Grupo Modelo's share of the export beer market in the U.S.

When InBev's Anheuser-Busch takeover formed AB InBev, Modelo became the focus of speculation that it would be gobbled up next. That still may be inevitable, says Lauren Torres, an HSBC Securities analyst in New York. Modelo can't match larger rivals' cost savings and faces a struggle to maintain its export growth pace, so the families, with 56 percent of the voting shares of the world's eighth-biggest brewer, eventually may

Predictions 2011

No. 4

Will international activity continue to fuel business growth in 2011?

"While Asia is moderating toward more normal high-growth rates, it is still the world's economic engine. Latin America as a whole is doing very well, and European GDP growth is performing better than many expected. We expect manufacturing and industrial production will continue to lead the economy forward in the near term and drive transportation volumes higher."
—FedEx Chief Executive Officer Fred Smith



FROM LEFT: ANDREW HARRER/BLOOMBERG; JIM LO SCALZO/BLOOMBERG

be persuaded to sell, says Torres. "The environment is getting tougher because things are consolidating," he says.

Modelo's sales outside Mexico rose 50 percent over the past five years. They accounted for 42 percent of 2010 revenue through September. Annual sales may reach 85 billion pesos ($6.8 billion) in 2011, according to a Bloomberg tally of analysts' estimates, more than twice the level of a decade earlier.

As its flagship Corona brand slides toward a fourth annual decline in the U.S. and the entire import market shrinks in America, partly due to the recession, Modelo is counting on lesser-known beers such as Modelo Especial and Victoria to spur sales north of the border. So far the plan is working. U.S. volumes for all Modelo brands rose 1 percent last month, compared with a 3 percent drop among all top-selling brands, says Alan Alanis, a JPMorgan Chase analyst, citing Nielsen data. That ranked it No. 4 among all beer producers in the U.S., with 5.4 percent of the market.

That's a drop in the beer stein compared with the 50.9 percent U.S. share for AB InBev's U.S. brands, including Budweiser. Yet among imports, Modelo beers held 43 percent of the U.S. market in the 12 months that ended in October, according to researcher Symphony-IRI Group. "We are growing in the U.S. faster than the market segment as a whole," says Jose Pares, Modelo's sales and marketing chief. "We have a complete and disciplined portfolio of export brands." It's that export success that boosts Modelo's profit margins–and allows it to keep would-be acquirers like AB InBev at arm's length, says Alanis. In fact, Modelo's operating margin of 26.5 percent last year was second only to AB InBev among major brewers.

Nonetheless, HSBC's Torres says Modelo's reliance on a network of local distributors around the world that's also shrinking through mergers is as much an obstacle to its future as waning sales of the maturing Corona. "Wanting to stay independent and be a Mexican beer company and still work through partners is what they believe should be their current business model," Torres says. "But times are changing." Ⓑ

—*Thomas Black*

***The bottom line** Grupo Modelo has prospered thanks to strong export demand for Corona beer. Industry consolidation could put its independence at risk.*

Briefs

by Caroline Winter

Sony
Focusing on image sensors



Sony will invest $1.2 billion over the next fiscal year to double its production capacity of image sensors—devices used in digital cameras and mobile phones to convert optical images into electrical signals—to 50,000 a month. The maker of Cyber-shot cameras will purchase a Toshiba factory that makes chips for PlayStation 3 game consoles and convert it into an image sensor production plant. Sony hopes to increase its share of the image sensor market to 30 percent, up from 10 percent for the year ending in March 2011. Toshiba, meanwhile, plans to improve the profitability of its chip business by phasing out low-end chips and teaming up with rivals such as Samsung to cut expenses.

Yukos Oil
A guilty verdict raises concerns

A Moscow judge found Mikhail Khodorkovsky, the jailed former head of Yukos Oil, guilty of embezzling crude in a trial that has heightened European and U.S. concerns about Russia's rule of law. Once Russia's richest man, Khodorkovsky is already serving an eight-year sentence for fraud and tax evasion. He was scheduled for release in October 2011 but now faces several more years behind bars. The businessman has called the charges retribution for his political opposition to Prime Minister Vladimir Putin, Russia's President at the time of his arrest. Yukos went bankrupt and was dismembered amid $30 billion of tax claims.

DuPont
Snapping up more corn and soy

DuPont's seed subsidiary, Pioneer Hi-Bred, has acquired two U.S. companies—Ohio-based Seed Consultants and Louisiana-based Terral Seed—as part of an expansion in corn and soybeans. Terms of the deals weren't disclosed. Pioneer says it also bought seed companies in Nebraska, Iowa, and Indiana in December. The acquisitions are part of Pioneer's push to make its seed genetics available through a wider network of distributors. Pioneer says it currently accounts for 5 percent of U.S. corn seed and soybean markets.



Skype Technologies
Compensating for a 30-hour crash

Skype Technologies will refund paying customers who couldn't use its service during a Christmastime outage that lasted more than 30 hours. The crash comes at a challenging time for Skype, which is trying to persuade companies to pay for its calling and premium services, such as group videoconferencing, in the runup to its initial public offering. Skype will give prepaid and pay-as-you-go users 30 minutes of free calling, and active subscribers will get a week's extension of their subscriptions. The cause of the disruption has not been disclosed.

Microsoft
Long odds in Las Vegas

Microsoft is poised to unveil a version of Windows designed for tablets at the Consumer Electronics Show that kicks off on Jan. 6 in Las Vegas, according to people with knowledge of the plan. The company hopes to step up competition with Apple by introducing a full computer operating system that works with technology by ARM Holdings, which currently runs on chips made by Qualcomm, Texas Instruments, and Samsung Electronics. That's in contrast to Apple, which uses a mobile-phone operating system as the basis for the iPad. Skeptics say Microsoft has little chance of catching Apple, which Goldman Sachs analysts say may sell up to 37.2 million iPads in 2011.

On the Move

TNK-BP Maxim Barsky's appointment as CEO delayed • **Cephalon** J. Kevin Buchi named CEO • **Groupon** Jason Child, former Amazon.com vice-president for finance, appointed CFO

CORN: CHRIS STEIN/GETTY IMAGES

worldmags

Contents ▶ The Ohio wheat farmer who could make or break health-care reform 28 ▶ Property tax appeals explode 29 ▶ As Republicans take back the House, corporate contributions flow their way 30 ▶ How census data will shift political power 31 ● Edited by Paula Dwyer



Chinese Plants Grow on U.S. Turf

▶ Its factories are getting the red carpet treatment stateside

▶ "The Tiananmen Square hurdle? You don't have that here"



On a spotless factory floor, workers wearing hair nets snap together metal frames, cables, and photovoltaic cells to produce metallic-blue solar panels. This sort of work could be done just about anywhere, yet China's **Suntech Power Holdings** as of October has been making the panels in a 117,000-square-foot plant in the Arizona desert. The sand-colored factory, about 20 miles west of Phoenix in the town of Goodyear, brings the company closer to its American customers and into compliance with "Buy American" requirements in some government contracts. The strategy seems to be working: Suntech plans to double its 75-person payroll by the end of next year.

For 20 years, U.S. manufacturers have decamped to China in search of cheaper labor and parts. Now Chinese companies increasingly are setting up shop in the U.S. to escape trade barriers, capitalize on the U.S. government's alternative energy push, and learn lessons that could help them in their home market. "It's a little unusual to see it coming the other way," says Wei Tai Kwok, Suntech's vice-president for marketing.

Chinese companies through September 2010 invested $2.81 billion in U.S. projects or acquisitions, vs. $1.73 billion in all of 2009, according to Rhodium Group, an economic research firm in New York. It's no longer just state enterprises buying up natural resources to fuel China's ravenous industries. Now the Chinese are investing more broadly in "retail, utilities, and especially new manufacturing," says Thilo Hanemann, Rhodium's research director.

The Chinese government encourages the westward expansion. After President Hu Jintao's Jan. 19 trip to Washington, he may visit a Chinese-owned company with American workers, possibly **Wanxiang America**, an Elgin (Ill.) auto parts company, say two business officials involved in the planning.

With unemployment hovering near 10 percent, U.S. officials have put aside concerns over unfair Chinese competition. "Chinese companies, thanks to government-backed loans, monopolies, and preferential treatment, are awash in cash and should be a source for investment in the U.S. economy—investment that would help maintain and create jobs in the U.S.," wrote Jon Huntsman, U.S. ambassador to China, in a diplomatic cable on Jan. 28, 2010, disclosed recently by WikiLeaks.

The red carpet treatment marks a sharp turnaround from 2005, when a Chinese state-owned oil company's $18 billion bid for **Unocal** was with-

PHOTOGRAPH BY MATHEW SCOTT FOR BLOOMBERG BUSINESSWEEK; DATA: RHODIUM GROUP.

Goodyear, Ariz.
Suntech Power Holdings
$10m
Solar panels

Galveston, Tex.
Xiangtan Electric Manufacturing
$105m
Engines and turbines

Moberly, Mo.
Mamtek International
$46m
Food, tobacco, beverages



Guo at the Goodyear plant: The vice-mayor baked him a cake

drawn after some U.S. lawmakers threatened to block Chinese acquisitions of strategically valuable U.S. assets. Some Chinese deals, such as a planned $200 million investment in a Mississippi steel mill, still trigger opposition. Dozens of others are proceeding. Near Corpus Christi, Tex., state-owned **Tianjin Pipe** next year plans to build a $1 billion steel pipe mill that will employ 500 to 600 people and circumvent 63 percent U.S. tariffs. On Nov. 30, **Pacific Century Motors**, formed by an affiliate of Beijing's municipal government, acquired **General Motors**' Saginaw (Mich.)-based **Nexteer Automotive**, which makes steering and driveline systems and employs more than 3,600 workers.

China absorbed $7 of outside investment for every $1 it sent to other countries as late as 2005, according to the International Monetary Fund. Next year the IMF expects Chinese outward investment for the first time to exceed the incoming flow. The yuan's slow but steady rise could be a further spur, making U.S. assets more affordable for Chinese buyers. The currency, up 2.5 percent against the dollar since mid-June, remains at least 25 percent undervalued, says the nonpartisan Peterson Institute for International Economics. "The yuan is going to continue to rise," says Donald Straszheim, senior managing director for ISI Group in the investment management firm's Los Angeles office.

For Suntech, the world's largest producer of solar panels, with headquarters in Wuxi, about 85 miles west of Shanghai, a U.S. assembly line means big savings on shipping costs and a foothold in a growing market. The company says it received a $2.1 million manufacturing tax credit through the economic stimulus package on an

investment of about $10 million, and became eligible to supply solar panels to installers that win government contracts with "Buy American" clauses. Camp Lejeune, the U.S. Marine Corps base in North Carolina, has one such job now out for bid.

Barry Broome, chief executive officer of the Greater Phoenix Economic Council, spent more than two years courting Suntech Chairman Shi Zhengrong, ultimately selling Shi on his vision of Phoenix as the world's solar capital. Goodyear officials chipped in three months of office space in city hall for a nominal $10 fee. The vice-mayor even baked a chocolate cake for Martin Guo, the plant's general manager. Broome now hopes to attract the company's suppliers. Trading with China isn't as controversial in Arizona as it is in Rust Belt states that have bled manufacturing jobs. "The Tiananmen Square hurdle? You don't have that here," he says. More than 1,000 people, including numerous victims of Arizona's housing implosion, turned up at a recent Suntech job fair.

Resurgent Republicans may put the brakes on the Obama Administration's green energy plans and slow sales of solar panels. Still, 29 states mandate utilities' use of renewable sources, says analyst Mark Bachman of Auriga Securities in New York, which has a buy rating on Suntech. Arizona utilities, for example, must derive 15 percent of their energy output from renewable sources by 2025. "All eyes are on the U.S. market at this moment," says Shi. "We have very high expectations and we do believe the U.S. market will grow substantially."

Suntech is using more advanced manufacturing equipment in its Goodyear plant than in Wuxi, allowing 30 Arizonans to produce the same number of solar modules as 100 Chinese. (U.S. production costs are still about 10 percent higher.) "If it works very well, we can integrate the same manufacturing technology in China," Guo says. "This would help Suntech China make [a] manpower reduction." Jobs for Americans and pink slips for the Chinese—just one more turnabout in the U.S.-China relationship. —*David J. Lynch*

The bottom line *Chinese companies are investing in the U.S. to bypass trade barriers and take advantage of government clean energy goals.*



Roscoe Filburn And the Commerce Clause

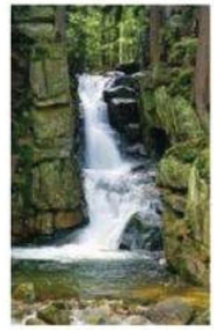
Filburn (above) lost his case opposing quotas. The decision influenced:



President Johnson shakes hands with Martin Luther King Jr. at the act's signing

1964
Civil Rights Act

Congress relied on the Supreme Court's interpretation of the Commerce Clause in *Wickard v. Filburn* in passing the landmark anti-bias law, reasoning that motels serve interstate travelers.



1972
Clean Water Act

Congress used its expanded commerce powers under *Filburn* when it passed the environmental law barring the release of toxins in rivers and streams.



1995
Gun Possession

The court struck down a federal law restricting gun possession near schools, saying *Filburn* doesn't apply unless commercial activity is involved.

Health Reform

Why Farmer Filburn Matters Right Now

▶ **The wheat farmer's 1942 case could determine the health law's fate**

▶ **"He just didn't feel it was right for the government" to impose quotas**

Before there was the Tea Party, there was Roscoe Filburn. Almost 60 years ago, Filburn took a stand against what he saw as federal meddling with his family farm in Dayton. When the Agriculture Dept. fined him for exceeding his government-imposed quota for winter wheat production, Filburn sued, taking his case all the way to the Supreme Court.

The court's unanimous 1942 ruling against Filburn broadened Congress' right to regulate interstate commerce and opened the way for sweeping environmental, consumer protection, and workplace safety laws. The case still reverberates: The Supreme Court's interpretation of *Wickard v. Filburn* could determine whether challenges to President Barack Obama's health-care law are successful.

Filburn was a fifth-generation farmer who would proudly boast that he had never worked for another person. He raised livestock and poultry on his 90-acre farm as well as crops. When Agriculture Secretary Claude Wickard invoked the 1938 Agricultural Adjustment Act to impose production limits to reduce the supply of wheat and boost prices, Filburn balked.

Though he accepted federal subsidies, Filburn didn't agree that the government could limit how much he could plant. In the fall of 1940 he planted winter wheat on 23 acres, more than double his 11.1-acre allotment. That led to a $117.11 penalty and the lawsuit. Although quotas were meant to help farmers after a quarter-century of hard times, "he just didn't feel it was right for the government of the U.S. to tell farmers how much they should grow," says his son, Roscoe Filbrun Jr. of North Fort Myers, Fla. (The spelling of the family name varied over the years.)

The issue at the Supreme Court was whether Congress could regulate grain that never left Filburn's farm and instead went to feed his animals or to make flour for consumption on the

A farmer's Supreme Court case led to sweeping new laws on civil rights and consumer protection

COURTESY MARY LOU SPURGEON; BLOOMBERG; ALAMY (3); BETTMANN/CORBIS; REDUX (2); GETTY IMAGES (2)

worldmags



2005
Marijuana Possession
The high court relied on *Filburn* when it allowed prosecution of marijuana growers under federal drug laws, even though the drug was not sold across state lines.



2010
Health Reform
Filburn could be pivotal in determining whether the insurance mandate in President Obama's health reform law is constitutional.

premises. A unanimous court said national and global markets were affected; because Filburn grew his own wheat, he didn't have to buy it from others. While the farmer's impact on the interstate market might be trivial, "his contribution, taken together with that of many others similarly situated, is far from trivial," Justice Robert H. Jackson wrote.

Few recognized the ruling's significance at the time, says Jim Chen, the dean of the University of Louisville's law school. It nonetheless ushered in an era of effectively limitless congressional power. The court has since used the commerce clause to uphold the 1964 Civil Rights Act, reasoning that anti-discrimination rules could be applied to a Georgia motel because it served interstate travelers, and to an Alabama restaurant because it bought supplies from other states.

Twenty-one states are opposing the 2010 health law, which requires individuals to buy insurance or pay a penalty, on the grounds that Congress can't use the commerce clause to regulate "inactivity," or the lack of insurance purchases. The Administration responds that, as with Filburn's decision to grow and consume his own wheat, not buying insurance would affect the national health-care market, defeating efforts to spread risks and costs over a larger population. The states point to what they say is a crucial distinction: Filburn voluntarily participated in a regulated market by growing wheat. A federal judge in Virginia on Dec. 13 agreed with the states, declaring the law unconstitutional, while two other federal judges have upheld it.

Since 1995, the Supreme Court has shown new interest in curbing Congress' power. That year the court struck down a federal law restricting gun possession near schools, saying *Filburn* doesn't apply unless a commercial activity is involved. A 2005 case bodes more favorably for the Administration: Relying on *Filburn*, the court allowed prosecutions under federal drug laws for marijuana grown and used locally for medicinal purposes. The health-care challenges, which the lower courts are still considering, could arrive at the Supreme Court as early as the fall of 2011.

None of the recent cases have the same economic importance as the health law—or the wheat program. The upheld production quotas helped spur the rise of specialized agribusinesses and the demise of the integrated family farm, Chen says. Within a generation, Filburn had sold his land to developers, making way for a subdivision and shopping mall. He died in 1987. —*Greg Stohr*

The bottom line *The future of health reform may rest on the Supreme Court's view of a 1942 precedent involving a wheat farmer and production quotas.*

Prediction 2011

No. 5

Will Republicans use their new power to try to block funding for regulatory agencies in 2011?

"If you're a business subject to regulation, the last thing you want is for there not to be adequate funding to process what's happening, because then they get backlogged. And then, you know, it's like the drug companies lobbying for money for the FDA."
—Representative Barney Frank (D-Mass.)



Taxes

Property Tax Appeals Flood Cities and States



▶ **The decline in real estate prices matches that of the Depression**

▶ **"We're constantly buying new file cabinets to hold all the cases"**

Cities and states, already straining to balance budgets, are in for another shock in 2011 as hordes of property owners appeal tax assessments, demanding lower levies that reflect battered real estate values. Less property tax revenue means more pressure on local governments to cut services, especially public schools and police and fire departments that rely heavily on those taxes.

U.S. home prices have tumbled 30.5 percent below their April 2006 peak, according to the 20-city S&P/Case-Shiller index as of Oct. 31, the latest available figure. That matches the decline in values during the Great Depression's darkest days, from 1925 to 1933, according to Yale University economist Robert J. Shiller, who helped develop the index.

In Michigan, where Governor-elect Rick Snyder has warned that hundreds of towns face financial crises, tax appeals are overflowing at the office of Patricia L. Halm, head of the state Tax Tribunal. "We're just getting swamped," says Halm, 54, who was appointed to the Lansing-based administrative court in 2003. "We're constantly buying new file cabinets to hold all the cases. We even have six surplus file cabinets in the courtroom."

The state's backlog of tax appeals involving levies above $100,000—mostly commercial and industrial properties—shot up to 14,236 this year from an annual average of about 6,000 during the past decade. The

backlog of claims for most residential properties, or those with tax bills below $100,000, was at 28,558 at the end of September, the most in the 13 years the state has kept detailed records. An appeal involves the property owner submitting an appraisal and other records to local or state appeals boards or courts to support the claim that a tax assessment is too high.

Clark County, Nev., which includes Las Vegas, had 8,300 appeals last year, up 38 percent from the year before and more than three times the number of appeals in 2008, says Rocky Steele, assistant director of assessment services. "It was a big year, the biggest we've ever had," he says. The county's taxable real estate value for the 2010-2011 fiscal year fell to $184 billion from $263 billion the prior year. The reduction will cost the county about $514 million in lost taxes. Almost all the hotel casinos and major property owners received reductions, Steele says.

Across the country, the situation is similar. New Jersey homeowners, who pay some of the nation's highest real estate taxes, filed a record 18,147 appeals in Tax Court during the fiscal year ending June 30, up 80 percent from fiscal 2007. In Atlantic City, where 11 casinos account for 74 percent of the property tax base, the city has exhausted a reserve for tax appeals that in 2006 held $26 million, according to a Nov. 4 report from Moody's Investors Service. All Atlantic City casinos have pending property tax appeals, says Moody's, which reduced the city's credit rating to three levels above speculative grade.

The outliers are Miami-Dade, Broward, and Palm Beach Counties in Florida, where appeals are declining. They have lowered assessments by about 22 percent from 2008 to 2010 after years of steep drops in home prices.

As the appeals wind through the legal process, assessors will have to adjust taxes to reflect market values, and property tax receipts will have to come down, says Michael A. Pagano, dean of the College of Urban Planning and Public Affairs at the University of Illinois at Chicago. "If the appeals are largely successful, they will generate a lot more." *—Jeff Green and Tim Jones*

***The bottom line** As real estate values plunge, many homeowners are appealing property taxes, adding to the financial woes of cities and states.*

Donor*	Pre-election Recipient	Amount	Post-election Recipient	Amount
AT&T	John Spratt (D-S.C.)	$10,000	Mick Mulvaney (R-S.C.)	$3,000
	Ike Skelton (D-Mo.)	$10,000	Vicky Hartzler(R-Mo.)	$3,000
	Rick Boucher (D-Va.)	$10,000	Morgan Griffith (R-Va.)	$2,000
UPS	Zack Space (D-Ohio)	$3,000	Bob Gibbs (D-Ohio)	$5,000
	Charlie Wilson (D-Ohio)	$9,000	Bill Johnson (R-Ohio)	$5,000
General Electric	Scott Murphy (D-N.Y.)	$11,000	Chris Gibson (R-N.Y.)	$1,000
	Suzanne Kosmas (D-Fla.)	$4,000	Sandy Adams (R-Fla.)	$2,000
BNSF Railway	Walt Minnick (D-Idaho)	$8,500	Raul Labrador (R-Idaho)	$2,500
	Chet Edwards (D-Tex.)	$6,000	Bill Flores (R-Tex.)	$5,000
Comcast	Rick Boucher (D-Va.)	$10,000	Morgan Griffith (R-Va.)	$2,500

DATA: FEDERAL ELECTION COMMISSION, CENTER FOR RESPONSIVE POLITICS
*ALL CONTRIBUTIONS MADE VIA POLITICAL ACTION COMMITTEES

Campaign Finance

Corporate Money Flows To GOP Winners

▶ **After betting on the wrong horse, companies quickly write checks**

▶ **"You want to make sure you're on the radar screen early"**

In 2010, corporations helped fill the campaign coffers of senior House Democrats scrambling to fend off a Republican tide in November. Now that Republicans have won a House majority, some companies are pivoting and writing checks from their political action committees to the 63 new Republicans who take House seats on Jan. 5.

AT&T, the largest U.S. phone company, made donations Nov. 19 to more than 30 newly elected lawmakers, including $2,000 to Morgan Griffith, who defeated Rick Boucher (D-Va.), chairman of the House communications subcommittee. South Carolina state Senator Mick Mulvaney, who ousted 14-term Representative John Spratt, and Vicky Hartzler, who defeated 17-term incumbent Ike Skelton in Missouri, each received $3,000 contributions from the AT&T PAC, according to the Federal Election Commission and the Center for Responsive Politics, a research group that tracks campaign finance. During the campaign, AT&T's PAC gave the maximum $10,000 donations to Democrats Boucher, Spratt, and Skelton.

The Federal Communications Commission has adopted net neutrality rules, which would bar AT&T, **Comcast**, and other Internet providers from interfering with Web traffic. Congressional Republicans may try to block such rules. Claudia Jones, a spokeswoman for AT&T, declined to comment. Comcast's PAC also gave $10,000 to Boucher during the campaign, and $2,500 to Griffith after his victory. Sena Fitzmaurice, a Comcast spokeswoman, declined comment.

Other companies writing post-election checks include **United Parcel Service**, **General Electric**, and **Burlington Northern Santa Fe Railway**. UPS is seeking legislation that would make it easier to unionize employees of rival **FedEx**. The UPS PAC "will never stop working to ensure that the voices and concerns of UPS employees are heard and recognized in Washington," says company spokesman Norman Black. GE is seeking government approval to sell a majority stake in **NBC Universal** to Comcast. GE also wants congressional support for an alternate engine it's developing for the Joint Strike Fighter; Defense Secretary Robert M. Gates says the engine is not needed. Peter O'Toole, a

Prediction 2011

No. 6

Which new financial rule will cause the biggest ruckus in 2011?

"The fight that people may not be expecting that may turn out to be pretty intense is over pay. A lot of people feel the pay arrangements on Wall Street are very unfair. Bank capital is a tough thing to explain. Bankers' pay, that's an easy headline."
—Simon Johnson, professor of entrepreneurship at the MIT Sloan School of Management



GETTY IMAGES



Facebook's bid to win over Russians page 32 ▶

GE spokesman, declined comment.

BNSF Railway, owned by Warren Buffett's **Berkshire Hathaway**, may be looking to fend off tougher rate regulations. Senate Commerce Committee Chairman Jay Rockefeller (D-W. Va.) hinted stricter controls may be necessary after releasing a Sept. 15 report showing railroad profit margins almost doubling to 13 percent in 2009 from 7 percent in 2000. A spokesman for BNSF, Steve Forsberg, did not respond to requests for comment.

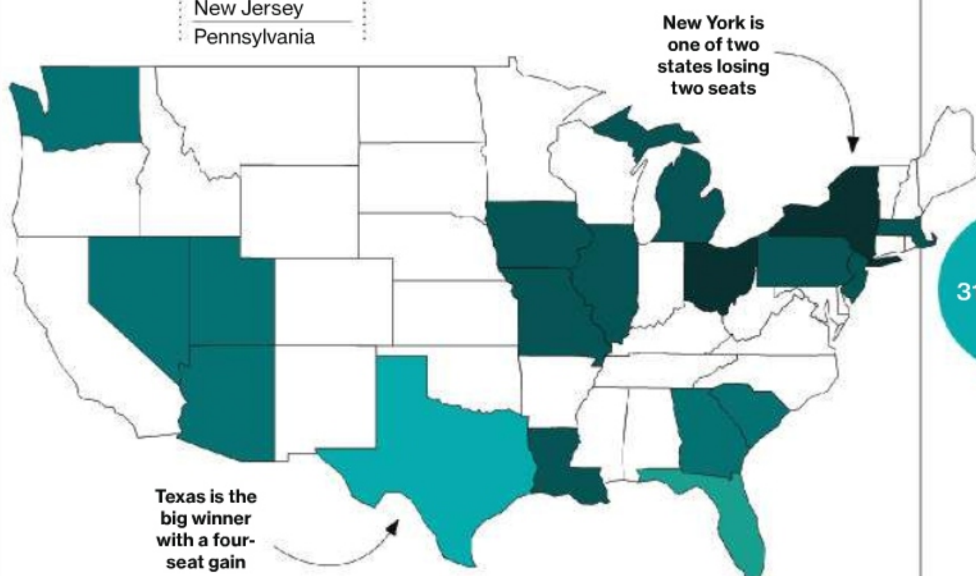
Companies trying to get their voices heard can't afford to wait until next year to make campaign donations, says Rogan Kersh, associate dean of New York University's Wagner School of Public Service. "We're in a greatly sped-up political cycle," Kersh says. "You want to make sure you're on the radar screen early." *—Jonathan D. Salant*

The bottom line *Corporate PACs are writing checks to freshmen Republicans before they take office, after at first supporting their Democratic rivals.*

Winners and Losers in Congressional Redistricting

Now that the U.S. Census has counted noses, eight states gain and 10 states lose House seats. Population grew in all states but Michigan, though overall growth was the slowest since 1930-40.

−2	−1	+1	+2	+4
New York	Illinois	Arizona	Florida	Texas
Ohio	Iowa	Georgia		
	Louisiana	Nevada		
	Massachusetts	South Carolina		
	Michigan	Utah		
	Missouri	Washington		
	New Jersey			
	Pennsylvania			



Census

For Pols, Demography Is Destiny

- ▶ Political power will follow population shifts West and South
- ▶ "It will set off an intense game of musical chairs"

The demographic center of gravity in the U.S. continues to shift toward sunnier climes and away from the industrial Midwest and Northeast. The changes, as measured by the 2010 decennial census, could have far-reaching political consequences, with Southern and Western states gaining a net 11 seats in the House of Representatives, likely setting off redistricting battles across the country. Those gains will also take electoral votes away from Northeast and Midwest states that Barack Obama carried in 2008, a possible boost for Republicans in the 2012 Presidential race.

Republicans will have an edge in redistricting, because they gained state offices in November

The census figures, released Dec. 21, show that the U.S. population has increased 9.7 percent since 2000, to 308,745,538, the slowest pace since 1930-1940. Eight states will gain and 10 will lose House seats. Of the eight gainers, five were won by Senator John McCain (R-Ariz.) when he was the 2008 Republican nominee. Obama carried 8 of the 10 states that lost seats. Among the states losing seats, only one, Louisiana, is in the South.

The states will now use the data to redraw political districts, sometimes pitting incumbents against each other. "It will set off an intense game of musical chairs," says Andrew E. Smith, a political science professor at the University of New Hampshire in Durham. "It's life or death for these guys."

Texas is the biggest winner, with a four-seat gain, while Ohio and New York are the biggest losers, dropping two seats each. As recently as 1940, New York had 45 seats. In 2013, it will have 27, the same as in 1810.

Republicans will have a redistricting edge because they gained state offices in the November elections. Reshaping congressional districts is done primarily by state lawmakers. Still, much of the population gain for states such as Texas, Florida, Nevada, and Arizona is the result of Hispanic growth. In 2008, Hispanics voted for Obama by a ratio of more than 2 to 1, according to the Pew Hispanic Center, a nonpartisan research group. Ⓑ
—John McCormick and Tim Jones

The bottom line *New U.S. census data give Republicans an edge in redistricting, though Hispanic population growth could help Democrats.*

Contents ▶ FCC's net neutrality rules: winners and losers 34 ▶ Gauging the Verizon threat to AT&T's Apple deal 34 ▶ Charlie Rose talks to Tim Wu 35 ▶ RIM's tablet is unlikely to dent the market 36 ▶ Hany Farid's software can spot manipulated digital photos 37 ● Edited by Cristina Lindblad



In Russia, Facebook Is More Than a Social Network

▶ The world's No. 1 social network wants to move up from fifth place in Russia

▶ "Russian is a very complex language, so we allowed users to translate the interface themselves"

Facebook is the world's largest social network site, with 500 million-plus members at last count. However, there are plenty of big markets where Mark Zuckerberg's creation isn't dominant. In Japan, Facebook doesn't rank in the top three, and the site isn't much of a force in Brazil or China, two populous countries where Internet usage is off the charts.

The outlook for Facebook in Russia may be more promising, despite the popularity of homegrown social network sites. Facebook officially launched its site in April and only ranks No. 5 so far, according to Internet tracker comScore, but its growth has been impressive. From January until August in 2010, its Russian operation has racked up a 376 percent increase in users, to 4.5 million, according to comScore data.

Russian "civil society is hemmed in, but its freedoms are limitless online," says one editor

Early last year the company cut deals with Russian wireless carriers **Beeline** and **Mobile TeleSystems**, so that their subscribers could tap the mobile version of Facebook. To overcome the language barrier, Facebook allowed users to suggest translations for the name of features not easily understood in Russian such as "poke" (as in trying to get another Facebook

ILLUSTRATION BY TOPOS GRAPHICS

user's attention), and then let the site's members vote them up or down. "Russian is a very complex language, so we allowed the users to translate the interface themselves so that it captures the complex grammar," says Javier Olivan, a London-based Spaniard who holds the title Head of International Growth at Facebook.

Its founder has made no secret of his ambitions to thrive in Russia, a market where other Western players, including **Google**, have struggled to get their footing. Speaking at an Oct. 17 event at Stanford University, Zuckerberg said that if Facebook succeeded in penetrating the Russian market, it might have a shot at doing the same in China, the country with the largest number of Netizens. Russians' heavy use of social network sites makes the country an ideal test-case. Russians spend 9.8 hours per visitor on a monthly basis on such sites—more than double the world average, according to comScore.

Why do Russians while away so many hours online? For one thing, there's the climate: Staying indoors and socializing via the Internet is much more attractive when winter lasts a good six months. Then there's the physical isolation, compounded by poor infrastructure, especially in cities like Murmansk, which lies north of the Arctic Circle.

Most importantly, though, there is a long tradition in Russia of relying on informal information networks for simple day-to-day survival. "In Russia, there is no sense that you can rely on the public or the system, so you've traditionally had to rely on a network of friends," says Esther Dyson, a venture capitalist who has been investing in Russia's tech sector for over a decade. In a country with weak institutions, "it's very natural for people to network for what they want." Even in these less oppressive, post-Soviet times, relationships are critical to everything from landing a job to wriggling out of a problem with authorities.

It's no coincidence that the Russian love affair with the Internet has blossomed at a time when citizens are once again seeing their political and media freedoms dwindle. "[The Web] has become a place where you have absolute freedom of speech, where you can say whatever you want, good or bad," says Ilya Krasilshchik, editor-in-chief of *Afisha*, a Russian lifestyle magazine and website. *Afisha* was one of the first Russian sites to incorporate the Facebook Like feature, which allows users to share content with friends on the site. Krasilshchik points out that Russia is different from China, where censorship prevails online. "We have this strange paradox where civil society is hemmed in, but its freedoms are limitless online."

9.8

Average hours spent per user on a monthly basis on social networks in Russia

376%

Growth in Facebook's Russian users from January to August in 2010

5

Facebook's ranking among social network sites in Russia

Not surprisingly, then, social networks have multiplied in Russia. Odnoklassniki.ru, a site modeled on Classmates.com with 17 million users, is the preferred destination for older, less tech-savvy users, along with being a popular dating site for Russians of all ages. Then there's Moi Mir, similar to **News Corp.**'s MySpace, with 20 million members.

The leader of the social networking pack is VKontakte, which is majority owned by **Mail.Ru Group**, a Russian investment fund specializing in Internet companies that also owns a small stake in Facebook. VKontakte, which has 28 million users, is inspired by Facebook. VKontakte has been dogged by claims that it has allowed the unauthorized posting of pirated music, movies, and other content free on its site. Mail.Ru declined to comment on allegations that VKontakte has engaged in such practices, though the company did disclose in a prospectus for a recent initial public offering in London that it is currently defending itself against several lawsuits. As for Facebook, the company "will not host any content that violates our terms of agreement," says Olivan.

One thing Facebook does have over its Russian competitors is cachet. Whereas Odnoklassniki.ru has become the domain of the older generation, and VKontakte the hangout of young middle- and lower-class Russians, Facebook is the network of choice for the urban and the urbane. Facebook's Russian users are generally of the wealthier, well-traveled, cosmopolitan variety, have foreign friends and tend to live in Moscow and St. Petersburg.

Facebook's status received a boost in September, when the company hosted its first developers' conference in Russia. The event, held in Winzavod, an up-and-coming art complex in Moscow, drew hundreds, including some prominent Russian Internet investors. The bulk of the crowd was made up of software developers hoping to transform their Facebook apps into riches.

Anton Nossik, the Russian Web guru who has a number of successful Web startups and used to run the company that owned the popular blogging platform LiveJournal, notes that in Russia sites such as Facebook and Google attract a particularly cosmopolitan set. Both are "for the global Russian, for the circle of people for whom the world doesn't begin and end with Russia." —*Julia Ioffe*

The bottom line *Facebook's user base is growing fast in Russia. But the social network needs to extend beyond the country's elites.*

Technology

Tech Policy

Net Neutrality Rules Aren't Always Neutral

Regulators on Dec. 21 limited companies' control of consumer access to the Internet and what flows over the Web. For some it's a mixed blessing. The Federal Communications Commission's net neutrality rules bar cable companies—say, Comcast—from blocking or slowing traffic from competing video providers such as Netflix. While the rules generally don't apply to wireless providers, they ban carriers such as Verizon Wireless from impeding rival phone services such as Skype. —*Todd Shields*

Fiber Owners
Internet service providers (ISP), cable companies, and other infrastructure owners feared that the FCC would impose stricter rules than it did.

Web Companies
Companies that deliver services over the Web won protection from ISPs seeking to block or slow down the delivery of their products.

Winners	Losers
AT&T	Netflix
Qwest Comm. Int'l	Walt Disney
Verizon Comm.	Apple
Comcast	Amazon.com
Cablevision Systems	U.S. consumers
Time Warner Cable	
eBay	
Skype	
Google	
Amazon.com	
Sprint Nextel	
T-Mobile USA	

Content Providers
Companies that deliver videos and other content may face higher fees and won't be able to negotiate deals with Internet providers that give priority to their own traffic. A video-on-demand service by Amazon.com, for example, could suffer.

Consumers
ISP and mobile Internet subscribers might have to pay more for heavy usage of an online service.

Mobile Carriers
Cellular providers got lighter regulation for mobile Web services than wireline carriers do for Internet service.

DATA: BLOOMBERG

Handsets

Handicapping the Clash Over iPhone Service



▶ Verizon is poised to muscle in on AT&T's lucrative Apple deal

▶ "It's like we're in a snow globe that's been shaken up"

Very soon, maybe by Valentine's Day, **Apple** will likely host one of its splashy product introductions to announce a new version of the iPhone that works on **Verizon**'s network. Customers are expected to stampede to the new pairing, leaving **AT&T**, until now the exclusive U.S. distributor of the iPhone, with an enormous problem.

Like most conventional wisdom, this expectation makes a certain amount of sense. Verizon enjoys a reputation for reliability. AT&T is notorious for dropping calls, especially in densely populated places like New York and San Francisco where iPhones are most common and cell towers get overloaded.

On Dec. 6, *Consumer Reports* published a survey of 58,000 readers who ranked AT&T as the worst wireless carrier for customer satisfaction—and by an even wider margin than its similarly dismal finish in 2009. The company brought up the rear in quality of calls, access to the Internet, and customer service. "AT&T," noted the *Consumer Reports* editors, "is now positioned in last place overall and in almost every market we rate."

And yet, while AT&T has reason to worry about losing the lucrative iPhone arrangement it has enjoyed since Apple introduced the device in 2007, the damage may not be as severe as many anticipate. At least initially, Verizon's iPhone may have weaknesses compared to AT&T's. The expense and hassle of changing carriers could also work to AT&T's advantage. "I'm sure some AT&T customers are sufficiently frustrated to switch, but the vast majority are at least happy enough," says Charles S. Golvin, an analyst with Forrester Research in Cambridge, Mass.

Apple's introduction of an iPhone for use on Verizon's network will come sometime after the Consumer Electronics Show in Las Vegas in early January, according to a person familiar with Apple's plans who is not authorized to discuss them publicly. Estimates from industry analysts of the resulting number of defections to Verizon from AT&T range from 1 million to 6 million. John Hodulik, an analyst at UBS Securities, comes in somewhere in the middle. He predicts that AT&T will sell 8.8 million iPhones in 2011, down from 15.6 million in 2010. Of the 13.3 million Hodulik expects Verizon to sell in 2011, about 2.3 million will be to AT&T refugees, he predicts. An additional 10 million will be current Verizon subscribers who upgrade from other devices, and the rest will come from other carriers.

Still, even if AT&T loses more than twice as many customers as Hodulik projects, the carrier will not suffer a fatal blow. If 6 million of its customers defect, the $6 billion in lost annual revenue would amount to about 10 percent of AT&T's wireless sales in 2011, according to UBS projections. The ➔

Predictions 2011

No. 7

Will Facebook or Twitter launch an initial public offering in 2011?

"Neither Facebook nor Twitter will go public in 2011, but both will continue to rapidly grow their users, and even more importantly both will monetize significantly above any projection for them in the market."
—Ron Conway, Silicon Valley investor and co-founder of SV Angel



FROM LEFT: ILLUSTRATION BY ALEX EBEN MEYER; NOAH BERGER/BLOOMBERG; BARB YANG; BRAD TRENT

Charlie Rose talks to

Tim Wu



The Columbia Law School professor, who coined the term "net neutrality," discusses how Web heavyweights are cornering digital markets

What does the recent net neutrality vote at the Federal Communications Commission mean?
It means there's now a federal net neutrality law. And that means it's illegal for a carrier, let's say Verizon, to block, say, Hulu or Bing. China blocks a lot of stuff for censorship reasons. In America, it's less about blocking and more about wanting to speed things up. You know, so Verizon has a partnership with Google; they speed up YouTube, and they slow down Hulu. And the net neutrality rule is supposed to prevent that.

And how did the sides line up in this debate?
Google has favored the net neutrality rule. But slowly, they've gotten closer to Verizon. AT&T, the great communications monopolist of American history, has always been opposed to net neutrality. So it's kind of a mixture. Generally, the [Internet] companies like net neutrality, and the phone and cable companies hate it.

What have you learned from your studies—whether it's motion pictures or AT&T, and now the Internet?
Well, this is what's so interesting—you see the same cycle repeat itself. Radio in the '20s, it was the new tech, and anyone could start a radio station. Film in the 1910s opened up. So these industries, once there's this new invention, go through incredible, exciting periods. The Internet had the same thing in the last 20 years ... anyone who starts a company becomes the next billionaire.

But what history shows is, over time, what was once a young, exciting new media becomes consolidated, increasingly closed, dominated by a monopolist or an oligopoly. And the question is whether that's happening again; whether, in subtle ways, the Internet itself is slowly becoming monopolized.

What's the case for this happening now?
Do you use Google? Everyone uses Google. They have a monopoly, which is actually quite astonishing in the sense of its penetration. By global search volume, it's in the 80-something percent range.

So the pattern is repeating?
If you look at most of these networks, social networking, Facebook; search engines, Google; downloaded content, basically Apple. In most online content, Apple's iTunes has a monopoly. So we're getting to an age where you can talk about a sort of Big Three or Big Four.

Is it because these companies have made breakthroughs? It's the entrepreneur's way, right?
The reason people like Google or Facebook is it's just simpler. If we go back to AT&T in the 1910s, we had a monopoly for 70 years, and why was that? It was easy—you picked up the telephone, and it worked. There's nothing wrong with that. But our desire to follow the leader does tend to lead to monopolization.

This is from a review of your new book *The Master Switch* in *The Boston Globe*: "Apple's iPhone and iPad, superb as they are, are each limited by design ... each of them can only run software that meets with Apple's approval. It's a business model quite familiar to those of us who recall the Bell System."
Right, I would say that Steve Jobs, of all the men out there heading large companies, has most of the characteristics of the great media moguls of history. He is the most similar: incredibly charismatic, fantastic products, incredible desire to control everything and establish a sort of empire. And so I'd say I would be the most concerned about Apple.

Because it's a closed system?
Yeah, it's completely closed.

Does this explain the rise of Google's Android phones?
Google's idea is that they win if systems are open. So in some sense it's ideological, in some sense it's commercial. They believe, "If we have an open platform we will win because we are better there." And they know that if they take on Apple head-to-head in a closed system they will lose.

What's your opinion of WikiLeaks and its recent impact?
One thing I talk about in the book is how radical the idea of the Internet was. And what WikiLeaks shows is that the Internet still has some weird tricks to play. It's still surprising people.

So is it a good thing or a bad thing?
I think that WikiLeaks itself deserves the full protection of the First Amendment. I don't know whether or not WikiLeaks should have disclosed the cables, but I think they have a right to disclose those cables. I think that's essential. Ⓑ



Watch Charlie Rose on Bloomberg TV weeknights at 8 p.m. and 10 p.m.

PHOTOGRAPH ILLUSTRATION BY CREDITTK

Trump tries branding golf properties page 40 ▶



$6 billion would be 4.8 percent of its total projected sales of $126 billion in 2011. AT&T is expected to try to mitigate the damage by promoting iPhone alternatives, such as cheaper devices that use Google's Android mobile software, says Mark Lowenstein, a former Verizon executive who is managing director of consulting firm Mobile Ecosystem.

Other losers in the unfolding iPhone tale may well be rival carriers **Sprint Nextel** and **T-Mobile**. There are no indications that Apple intends to make an iPhone for either of them. Without the Apple magic, their subscriber rolls could fall in 2011 by 650,000 and 950,000, respectively, Hodulik says.

AT&T has been getting ready for the day that Apple shares the iPhone with another carrier. Over the past year it has played a carrot-and-stick game with consumers. In part by easing the cost of upgrading to Apple's new iPhone 4, it enticed 15 million of its 23 million iPhone subscribers to sign new two-year contracts. Meanwhile, last June, AT&T hiked early contract termination fees from $175 to $325, giving users a reason to think twice about switching.

"We are the industry leader in smartphones," says AT&T spokesman Fletcher Cook. Current iPhone users with AT&T service can make a call and use the Internet simultaneously—if, for example, they want to search for a restaurant while continuing a conversation. Verizon's network is based on different technical standards, which do not permit this kind of multitasking. In addition, AT&T's network offers greater speed when sending e-mail, surfing the Web, or playing online games, according to Global Wireless Solutions in Dulles, Va.

"We operate the nation's fastest network, and we plan on making it even faster," says AT&T's Cook. The advantage of greater speed comes into play only when a user has steady cell coverage, of course. When there are too many iPhone users relying on the same tower, some are likely to get dropped. That explains AT&T's bruised reputation for service.

Verizon has largely avoided coverage snafus while handling soaring demand. It has invested heavily in powerful cell tower gear and new fiber-optic lines to connect the towers to the Internet. "Even if Verizon's iPhone customers go wild next year, [the carrier] can easily handle the capacity," says Michael Howard, co-founder of Infonetics Research in Campbell, Calif.

Verizon has also taken the lead in rolling out so-called 4G service, which offers far more speed than today's 3G networks. Verizon recently began selling 4G service in 38 markets across the country, and it owns more of the wireless spectrum than AT&T. (AT&T's $1.9 billion deal announced on Dec. 20 to buy additional spectrum from mobile chip maker **Qualcomm** will help close the gap.)

Much remains uncertain in this wireless duel. Both AT&T and Verizon have staked their futures on 4G, but neither will have broad-based coverage for the new technology anytime soon. "Right now, it's like we're in a snow globe that's been shaken up," says Roger Entner, an analyst with the research firm Nielsen. "In six months or a year, everything will settle down as these new [4G] networks come on line."

Only then will discerning consumers really be able to compare AT&T's iPhone service to that of Verizon. And only then will the cost of AT&T's loss of its exclusive hold on the iPhone be clear.

—*Peter Burrows*

The bottom line *The conventional wisdom about the impact of AT&T's loss of exclusive service for the iPhone may require rethinking.*

Predictions 2011

No. 8

Will Apple's new Mac App store launching on Jan. 6 be a hit like iTunes?

"This could revolutionize software distribution. You're not going to be able to sell a $39 shrink-wrapped box if people can get a competing product by just dragging a mouse, using a credit card already on file, and paying $5.99."
—Jason Izatt, a developer who makes a mileage-tracking iPhone application called Milebug



Tablets

RIM's PlayBook Rally May Fizzle



▶ Some say the device will arrive too late to make a dent in the market

▶ "It'll be a modest seller ... the iPad will likely do 10 times as much"

Research In Motion's stock is up about 37 percent since the start of September, primarily because of its tablet device, due out in the first quarter. Yet the share rally may be overdone. Some analysts are warning that RIM's PlayBook may be late to the tablet race in a market led by **Apple**'s iPad. "It'll be a modest seller, and the iPad will likely do 10 times as much," says Shaw Wu, an analyst at Kaufman Brothers in San Francisco who cut his RIM rating to "hold" in early November. He estimates RIM will ship 1 million PlayBooks in 2011 at most.

The tablet's sales will show whether RIM can find growth beyond its iconic BlackBerry handset, which has been losing users to Apple's iPhone and devices that use **Google**'s Android software. Bloomberg surveyed 17 analysts on their expectations for PlayBook sales in the first year of introduction. The median forecast was for RIM to ship 2.55 million tablets at an average price of $430. (RIM has yet to price the PlayBook but says that it will cost under $500.) On that basis, the Waterloo (Ont.)-based company would realize sales of $1.1 billion from its new device,

37%

RIM's stock price appreciation since the start of September

CLOCKWISE FROM TOP RIGHT: PHOTOGRAPH BY JASON GROW FOR BLOOMBERG BUSINESSWEEK; COURTESY JASON IZATT; JEFF J. MITCHELL/GETTY IMAGES; DAVID PAUL MORRIS/BLOOMBERG

equal to 4.8 percent of projected overall revenues. RIM spokeswoman Tenille Kennedy declined to comment on analysts' estimates for PlayBook sales.

Steven Fox, an analyst at Crédit Agricole Securities in New York, figures Apple will have sold some 17 million iPads by the time RIM's PlayBook hits the market. (Apple's tablet went on sale amid much marketing fanfare in April.) In an early December note to clients, Fox wrote that the iPad is now "the early incumbent" in this market and "that RIM would need to one-up in its features" to make inroads.

The iPad's dominance of tablet computing will "change when we're in the market," says RIM Co-Chief Executive Officer Jim Balsillie. Video is one area where the PlayBook beats the iPad, he says. RIM's device supports Adobe Systems' Flash technology that underpins much of the video content online; the iPad doesn't. Apple CEO Steve Jobs has said devices such as the PlayBook will be "dead on arrival" because they are too small to compete with the iPad. The PlayBook sports a 7-inch screen, vs. iPad's 9.7-inch display.

At least six analysts have reduced their rating on RIM shares in the past seven weeks, and fewer than half those tracked by Bloomberg now recommend buying. Apple's stock is recommended by 90 percent of analysts following it. BGC Partners analyst Colin Gillis says that despite the Playbook-driven rally, "the actual competitve positioning and landscape hasn't changed at all."

Some are keeping the faith in RIM. Matthew Robison of Wunderlich Securities in Denver reiterated his "buy" rating on the stock in a Dec. 10 research note. He said the PlayBook is compelling because it works with the BlackBerry, letting those hooked on the RIM smartphone to "continue using their preferred communications device." RBC Capital Markets' Mike Abramsky lists RIM among his top picks, and in a Dec. 8 note to clients touted the PlayBook's powerful QNX software, which is set to be the platform for all future RIM devices. However, Abramsky added: "Apple has a huge lead and Android devices are proliferating."

—Hugo Miller

The bottom line *Despite an initial surge in optimism, many analysts are now doubtful that RIM's tablet will bolster the company's competitive standing.*

Innovator

Hany Farid



A Dartmouth computer scientist and forensic imaging specialist has come up with a way to tell whether a digital photograph is authentic

A warning to anyone trying to pass off faked photos as real: Hany Farid is on to you. The Dartmouth College computer scientist is developing digital forensics software that can instantly tell whether an image has been manipulated, and what make and model of camera captured it. It's "exactly like gun ballistics," says Farid, 44. "If Photoshop touches that image, we will know about it."

Much as a rifle barrel imprints a unique pattern of grooves on bullets, digital cameras have electronic signatures—minute variations of resolution and image compression in the images they produce. Farid and his students received permission from photo-sharing site Flickr to download millions of images and build a signature database of every one of the 10,000-plus digital camera models ever made. To verify a picture, Farid's system checks it against that database to identify the equipment used. It then looks for any variations in the signature, which would indicate fakery. If the system finds traces of Adobe Photoshop, which also leaves a signature (and is the most common image manipulation program), that's a sure sign of picture alteration.

Farid plans to sell his software, though he hasn't decided whether to start his own company or partner with Adobe, which is helping to develop the technology. The program may be useful to law enforcement agencies that need unaltered photographs for court evidence, says Stephen A. Saltzburg, a law professor at George Washington University. Newspapers might use it to determine the authenticity of freelance photos. People will inevitably try to outsmart the program, "but we're going to make it pretty hard for them," says Farid. "You're going to have to work. And right now, you don't have to work."

Farid initially didn't want anything to do with the photo business. As the son of an Eastman Kodak chemist, he says he wanted to cut his own career path. In college, his mother persuaded him to take a class in computers after *Time* declared them "Machine of the Year" for 1982. Farid says he tried so hard to steer clear of the profession of his now-retired father that "I apparently ran in a circle," and by 1999 he was working in digital imaging.

One limitation of Farid's technology: It only shows that an image has been doctored. Figuring out what was altered, and how, requires other techniques. Farid uses 3D modeling software that determines whether the shadows in a photo all come from consistent light sources. If the shadows fall at impossible angles, the shot is probably a composite of multiple images. In a 2009 paper, he applied this technique to a picture of Lee Harvey Oswald long thought to be phony. Farid concluded the photo was real, outraging Kennedy assassination conspiracy theorists. "I wanted the photo to be fake. That would have been such a cooler result," he says. "Now people think I'm part of the conspiracy." Ⓑ *—Oliver Staley*

Problem ▶ Photoshop is so good, it's hard to tell whether an image is faked

Solution ▶ Locating digital signatures left by cameras

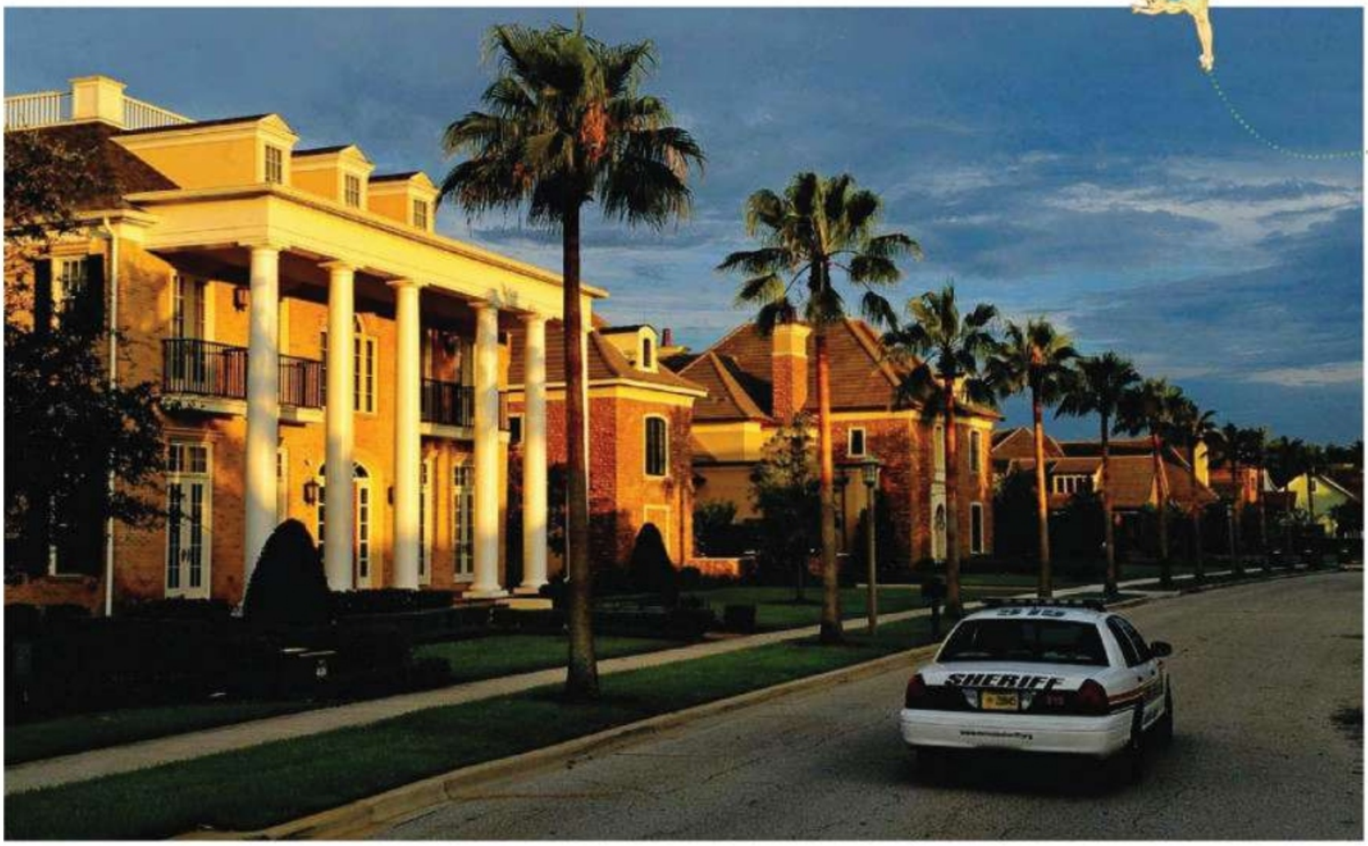
Pedigree ▶ Farid's father was a chemist at Eastman Kodak



BLACKROCK

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Markets&Finance



Real-World Woes Come to Disney's Fantasy Town

▶ Celebration's foreclosure rate is well above the Florida average

▶ People thought "Tinker Bell had sprinkled the town with pixie dust"

Walt Disney built Celebration, Fla., as an idealized vision of a circa-World War II small town, where litter-free streets are lined with homes, some featuring white picket fences and front porches. That doesn't mean Celebration can escape 21st century problems. The town's foreclosure rate is about double the state's, as homeowners who paid a premium for a version of utopia fall behind on their mortgages. In December a resident on the verge of losing his house shot himself after a 14-hour standoff with police. Three days earlier the 16-year-old town had its first murder when a man was bludgeoned with an ax. "A lot of people bought homes in Celebration thinking Tinker Bell had sprinkled the town with pixie dust," says Michael Olenick, chief executive officer of mortgage data firm Legalprise in West Palm Beach. "Reality is hitting hard."

The foreclosure rate in Celebration since the beginning of 2009, based on notices that initiate cases, is one for every 20 residents, compared with one per 48 in Florida as a whole, according to Legalprise. Celebration home values have dropped as much as 60 percent from their 2006 peak, while statewide values are down 51 percent, data from Seattle-based research firm Zillow.com show. Foreclosures in Celebration are occurring at a higher rate in part because property owners in financial trouble are walking away from vacation homes in the town, where real estate sells for about 30 percent more than it does in surrounding communities, according to Olenick. Before the recession, people were willing to pay more for living in a Disney "fantasyland," he says.

Vacation home owners in financial trouble are walking away from their property in the community

Craig Foushee, 52, barricaded himself in his home on Dec. 2, shooting at sheriff's deputies and mem-

MICHAEL WILLIAMSON/THE WASHINGTON POST/GETTY IMAGES; TINKERBELL: AF ARCHIVE/ALAMY

bers of a SWAT team before turning the gun on himself. His home had been in foreclosure since October 2009, according to legal filings.

The Osceola County Sheriff's Office says there is no connection between Foushee's death and the murder of Matteo Giovanditto, 58, who was killed in late November by an acquaintance who confessed, according to a statement on the website of the Sheriff's Office. Residents are "in shock" after the deaths, says Angela Sessoms, who has lived in Celebration for 10 years. She recalls visitors saying the town looked like the set of a Disney movie. "With the SWAT team, the roads barricaded, and the school in lockdown, it was like a different kind of movie set," she says.

Disney started building Celebration in 1994, and the first residents arrived in 1996. Located on the southern border of Disney World, 25 miles south of Orlando, it was designed by Robert A.M. Stern, dean of the Yale University School of Architecture, and Jaquelin Robertson of Cooper, Robertson & Partners in New York. The design of the development is called New Urbanism, also known as neotraditionalism, emulating 1950s mixed-use neighborhoods where it was easier to walk than to drive.

The 10,000-person town is 12 minutes from Disney World's Magic Kingdom and has a backdoor access road to the park. The median home value, including single-family properties and condominiums, was $250,800 in October, almost twice the $127,300 median value for the entire state, according to Zillow. For $529,000, buyers can get a four-bedroom, 2,800-square-foot home with a wraparound porch on about a sixth of an acre. In the second half of 2006, at the height of the real estate boom, the least expensive single-family house fetched $350,000, according to Kathleen Carlson, owner of Imagination Realty in the town's center. In the same period this year, the lowest sale price was $210,000.

Lexin Capital, a New York-based private real estate investment firm, bought the 18-acre Celebration downtown from Disney in 2004. Mike Nunez, a spokesman for the company, didn't return calls seeking comment. Disney still owns some commercial property in Celebration, according to Marilyn Waters, a spokeswoman for the Burbank (Calif.)-based company.

The town's Architectural Review Committee maintains strict control over the appearance of properties, dictating paint colors, regulating holiday decorations, and overseeing the size of political signs. Celebration shows its Disney heritage in annual seasonal shows, each with special effects originally designed by the entertainment company. In October leaf-shaped confetti shoots out of lampposts in the village center to simulate colorful falling foliage. During December the posts emit what locals call snoap–soap suds that look like snow. The snow falls four times a night, on schedule, and dissipates without shoveling. "Two of my grandchildren think we live inside Disney World, with Mickey Mouse," says Sessoms. "Except for the recent violence, I can understand why they would think that."

—*Kathleen M. Howley*

The bottom line *Celebration's carefully controlled environment hasn't been impervious to real-world woes such as foreclosures and lower home prices.*



FROM TOP: ANDREW MILLIGAN/PA/AP PHOTO; JOAN MARCUS/PUBLIC THEATER/BLOOMBERG

Real Estate

Trump Tests His Brand On the Golf Links

- Seeing bargain prices, he invests in courses as demand slows
- "The name is hotter than ever.... It's hot as a pistol," the developer says

Donald Trump is betting his name will boost the value of his golf courses even as the premium for the brand declines on condo properties and ratings slide on his show, *The Apprentice*. The real estate developer turned TV personality has acquired nine golf properties in the U.S., including four since 2008. In July he started building a £750 million ($1.15 billion) golf course and resort in Scotland.

Trump says putting his name on the courses increases membership and the fees he can charge. Elsewhere, the record is mixed. The Trump name hasn't prevented the failure of real estate developments in Florida and Mexico. Nor



has it helped his New York condos sell for more than comparable apartments in the city, according to Sofia Song, vice-president for research at StreetEasy.com, which compiles real estate listings. At the same time, Trump's hotels in New York and Chicago are outperforming their competition based on occupancy rates and room prices.

With the Trump name appearing on vodka, health products, mattresses, furniture, cuff links, shirts, ties, and a seminar company, the brand has been devalued, says Josh Feldmeth, chief executive officer of the New York division of consulting firm Interbrand. "He has cashed out."

Trump, 64, says the popularity of his brand continues to grow and has helped him navigate the recession better than most developers. "The name is hotter than ever," he says during an interview at his 26th-floor office in Manhattan's Trump Tower, where he has a view of Fifth Avenue, the Plaza Hotel, and Central Park. "It's been hot as a pistol." After taking a break to greet Kate Gosselin, star of the onetime reality show *Jon & Kate Plus 8*, Trump says: "If Trump wasn't doing well, the stars don't come up and kiss my ass."

The brand was worth $3 billion in 2008, says Jonathan Low, a partner at West Palm Beach (Fla.) consulting firm Predictiv who was hired by Trump to conduct an analysis for the bankruptcy proceedings of Trump Entertainment Resorts, the operator of three Trump-branded casinos in Atlantic City, N.J. "Based on data we've received subsequently," says Low, "I don't believe it's diminished significantly."

Trump buildings in Manhattan–both those he owns and those he licenses his name to–command prices similar to or lower than comparable buildings, according to an analysis by StreetEasy.com of sales in the third quarters of 2008, 2009, and 2010 at six Trump buildings. "There's no obvious premium for the Trump name," says Song. Trump says the comparisons are unfair because the Trump apartments that sold often were smaller or had worse views than the ones they were measured against. He calls all the buildings "very, very successful."

The same can't be said of Trump-licensed condominiums in Tijuana, Mexico, and Tampa and Fort Lauderdale. At least 300 people have joined lawsuits against Trump, seeking refunds of their deposits on those projects, which weren't completed. Trump has denied responsibility and sought to be dismissed from the suits because he wasn't the developer. On Dec. 22 a district court judge overseeing one case in Miami dismissed 11 of 13 counts filed against the **Trump Organization**, including those naming it as the developer of the Trump International Hotel & Tower in Fort Lauderdale. In a separate case, a Broward County (Fla.) judge in October rejected Trump's motion to be dismissed from a lawsuit against the Trump International Hotel.

In addition to owning golf courses, the billionaire stars in *Donald J. Trump's Fabulous World of Golf* on the Golf Channel, which starts its second season on Jan. 31. *The Apprentice* series on NBC ended its 10th season on Dec. 9 in 82nd place, drawing 45 percent fewer viewers than the previous season, according to NBC. The audience has shrunk 40 percent since 2007.

Trump is expanding his golf holdings as the number of private clubs in the U.S. fell 3.4 percent this year, to 4,256, from 2008, according to the National Golf Foundation. To Trump, the downturn represents a buying opportunity. "Golf clubs, I think, are some of the few cases where we're able to get great, great distressed deals," says Trump's daughter, Ivanka, the Trump Organization's executive vice-president for development and acquisitions.

Prices are so appealing that Trump says he is using his own money rather than licensing his name. He paid $3.7 million in December 2009 for a lease with an option to buy the Pine Hill Golf Club in New Jersey out of foreclosure. He changed the name to Trump National Golf Club Philadelphia after the nearby city, repainted the brown clubhouse white, and increased membership by 200, to 330, he says. In June, Trump won preliminary approval to develop a 1,400-acre estate north of Aberdeen, Scotland. "They wanted Trump," he says. "If my name was anything else ... zero chance–zero."

—John Gittelsohn and Nadja Brandt

The bottom line *Trump is betting the power of his brand will boost profit at golf properties, even as it has had mixed results in other projects.*

Banking

Hollywood Banker Eyes A Big Role on Broadway

▶ **Russell Goldsmith wants to expand City National's theater business**

▶ **"You always feel like he's involved. That's the secret"**

Al Pacino's success in his latest Broadway role is also a coup for Russell Goldsmith, a banker whose main offices are more than 3,000 miles away. Goldsmith is the chief executive officer of **City National**, a bank based in Los Angeles whose logo adorns the checks paid to actors and employees in the current production of *The Merchant of Venice*, which stars Pacino as Shylock. The show is another in a long list of Broadway clients for Goldsmith, who opened a second office in



Al Pacino

Nissan's huge all-electric bet page 48 ▶

New York in December in an effort to capture more of the city's entertainment business. "We see a lot of opportunity in Manhattan," Goldsmith says.

To support his expansion in New York, Goldsmith is relying on contacts built up from years in the entertainment industry and a family banking history with Hollywood that goes back almost half a century. Founded in Beverly Hills in 1954, City National, often called the Bank to the Stars, counted Frank Sinatra and Marilyn Monroe among its clients. It now has $21.8 billion in assets, making it the 26th-largest commercial bank in the country.

On Broadway, City National's first client was the musical *Monty Python's Spamalot*, which opened in 2005. Since then the customer list has grown to include 10 of the 33 Broadway shows now running, Goldsmith says, including *Mamma Mia!* and *The Addams Family*. The bank doesn't offer financing for shows, a highly speculative business. Instead, it provides treasury and checking accounts for productions, along with mortgages and wealth management services to producers, performers, entrepreneurs, and attorneys. The entertainment business accounts for about 20 percent of the bank's revenue, Goldsmith says.

Goldsmith, 60, began his career as an attorney after graduating from Harvard Law School in 1975. He went on to become the chief operating officer of entertainment company **Lorimar**, and then the CEO of Republic Pictures, an independent production and distribution company. He sold Republic to **Spelling Entertainment Group** for about $100 million in 1994. The next year, Goldsmith became CEO of City National, succeeding his father, Bram, who had held the post since 1975. Bram is now chairman.

The bank has not had a quarterly loss since 1993. In the three months ended Sept. 30, it posted a profit of $35.1 million on revenue of $254.5 million. There have been some missteps. In February the bank lent $2.6 million to Kenneth I. Starr, the investment adviser to the rich and famous. That was about three months before Starr was indicted for cheating 11 clients, including Jim Wiatt, the former head of the William Morris Agency, and actress Uma Thurman, out of $59 million. Starr pleaded guilty to fraud in September. City National sued Starr and won a default judgment in the same month.

Goldsmith sets the bank apart from most rivals by offering a more intimate customer experience, says Bob Boyett, one of the producers of *Spamalot*. City National came through for him on an earlier project when he needed advice and his business manager was unavailable. Boyett called the bank, identified himself as an entertainment client, and was told he could speak with anyone in the division. "What I learned that day is you can call the entertainment division at any time and every single employee knew who you were, was extremely helpful, and could get anything done when you needed," Boyett says. "The big banks can't do that; they just have too many people."

Bill Haber, a co-founder of **Creative Artists Agency** and producer of more than 40 shows, including *Spamalot*, says bankers must be "immediately accessible" to meet the needs of Broadway at all hours of the day. City National has delivered cash by courier and gone out of its way to fix problems, says Haber, who has known Goldsmith for 30 years. "It's a family business, and Russell is the head of the family," he says. "Even though he's the CEO, he touches everything, so you always feel like he's involved. That's the secret." —*Dakin Campbell*

The bottom line *Under Goldsmith, Hollywood's "Bank to the Stars" has opened a second New York office to expand work with Broadway productions.*


Spamalot

Investing

The Stock Rally May Still Have Legs in 2011

▶ Robust profits and corporate cash could power a third year of gains

▶ "Good, with a chance for great" is one analyst's outlook

If strategists at Wall Street's biggest banks have it right, the Standard & Poor's 500-stock index is heading for its biggest three-year advance since the 1990s. The benchmark gauge for American equities will rise 9 percent from its Dec. 27 close, to 1,374, by the end of 2011, according to the average forecast of 11 strategists in a Bloomberg News survey. That would bring the cumulative increase in stock prices since 2008 to 54 percent and make for the best three-year return since 1997 to 2000.

The 11 forecasts range from a high of 1,550 to a low of 1,250. In January the average strategist forecast was for the S&P 500 to finish 2010 at 1,225. It closed at 1,258 on Dec. 27. Market analysts say earnings will hit record highs in 2011, keeping valuations below historical averages at a time that government spending aids the economy.

Goldman Sachs' David Kostin, the most accurate U.S. strategist of 2010—he predicted the index would finish at 1,250—says sales growth will send the S&P 500 up 15 percent, to 1,450, through the end of 2011. "Company balance sheets have never been stronger," he says, citing Goldman Sachs data showing corporations hold more than $1 trillion in cash, the most ever relative to the value of their assets. "We expect S&P 500 firms will increase spending in all categories, with the fastest growth in acquisitions and share repurchases." He is the second-most-bullish of the strategists surveyed.

Barry Knapp, the New York-based head of equity strategy for **Barclays**, expects the S&P 500 to reach 1,420. "I've tried to think about all the risks," he says. "I just think the outlook is favorable, so favorable that I struggle to see how the equity market doesn't perform well."

One potential risk is shrinking profit margins, according to

JOAN MARCUS/BONEAU/BRYAN-BROWN, INC./PUBLIC THEATER/BLOOMBERG

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Predictions 2011

How markets, rates, and economic indicators will perform this year, compiled from Bloomberg surveys of economists, investors, and others, as well as from the National Association of Home Builders

Nº 9
Price of Oil

Dec. 27, 2010, price: $91/bbl.



$87
2011 avg./bbl.

Nº 10
Price of Gold



$1,400
2011 avg./troy oz.

Dec. 27, 2010, price: $1,384/troy oz.

Nº 11
Top Farm Commodity

2011
Cocoa
–3%
Cocoa is expected to be the best of a bad lot as commodity prices tumble

2010
Cotton
+93%
Cotton prices reached a record $1.59/lb. before easing late in the year

Nº 12
Federal Funds Target Rate

2011 average
0.50%
2010 average: 0.25%

Nº 13
The Dollar vs. the Euro

2011 average cost of one euro
$1.30
2010 average: $1.33

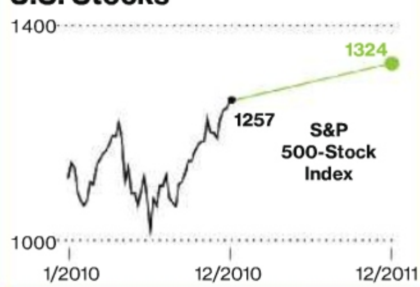
Nº 14
10-Year Treasury Yield

2011 average
3.53%
2010 average: 3.18%

Nº 15
European Stocks



Nº 16
U.S. Stocks



Nº 17
Chinese Stocks



Nº 18
U.S. Unemployment Rate

The November 2010 rate was 9.8%

9.4%
Avg. monthly rate in 2011

Nº 19
U.S. Housing Starts

Growth in 2010 was 6.3%

20%
2011

Nº 20
U.S. GDP

Growth in 2010 was 2.8%

2.6%
2011

DATA: ALL FORECASTS ARE FROM BLOOMBERG SURVEYS EXCEPT FOR HOUSING STARTS, WHICH IS FROM THE NATIONAL ASSOCIATION OF HOME BUILDERS. OIL IS WEST TEXAS INTERMEDIATE. FINAL STOCK PRICES FOR 2010 ARE AS OF DEC. 27. GDP FORECAST IS YEAR-OVER-YEAR GROWTH.

Citigroup's Tobias Levkovich, who estimates a 3.3 percent gain for the S&P 500 next year, to 1,300. That's the second-most pessimistic projection of the 11 strategists. While Levkovich is upbeat about the first six months of the year, saying the market could exceed his estimate as businesses spend and confidence returns, the second half won't be as positive. He's concerned that profit margins, which have expanded to the highest levels since 2007, may begin to shrink.

The strategists in the Bloomberg survey predict S&P 500 combined profits will reach $92 a share in 2011. The index trades at 13.5 times that estimate, compared with a median price-earnings ratio of 16.4 since 1956, according to data compiled by Bloomberg. The S&P 500's earnings yield, or annual profit divided by share price, was 6.45 percent on Dec. 13. That was 3.13 percentage points more than payouts on 10-year Treasuries and about 2.4 points more than the average interest on U.S. corporate bonds as measured by Barclays.

The spread between the S&P 500 earnings yield and corporate bond yields is close to the widest in more than two decades. That suggests stocks are more attractively valued than bonds, which may spur investments by individuals, institutions, and companies in 2011, Kostin says.

Jonathan Golub at **UBS** in New York expects a 5.3 percent rise, to 1,325, in the S&P 500 through 2011, fueled by sales growth of as much as 7 percent for companies in the index. Next year looks "good, with a chance of great" for equities, he says. "We're entering into a self-sustained recovery." Record cash means companies can increase mergers, acquisitions, and share repurchases, Golub says.

Earnings valuations based on profit estimates for 2011 show prices have been depressed by an overly pessimistic view of the economy, he says. "As the economy continues to surprise on the upside, there's a process by which the market starts to discount greater success," says Golub. "I'm not calling for a lower-return year." Ⓑ

—Alexis Xydias and Whitney Kisling

The bottom line *Prospects for strong earnings, plus the cash on balance sheets, have strategists seeing a 9 percent gain for the S&P 500 in 2011.*

Bid & Ask

by Cristina Lindblad



1. **Uralkali,** a Russian potash producer, is buying a peer, Silvinit, for $7.8 billion. The combined companies will account for 17 percent of global output of the fertilizer.

2. **TD Bank Group** is upping its bet on the U.S. with its $6.3 billion purchase of Chrysler Financial, the lender formerly owned by Cerberus Capital.

3. **SK Energy** of South Korea agreed to sell its Brazilian oil refining unit to Denmark's Maersk Oil for $2.4 billion.

4. **AT&T** is paying $1.9 billion for a chunk of wireless spectrum owned by chipmaker Qualcomm. The acquisition may help the mobile network carrier alleviate its congestion problems.

5. In the largest U.S. transaction involving a single building, **Google** inked a deal valued at about $1.8 billion for a former warehouse in Manhattan's Chelsea section. Google is already the biggest tenant on the site, which has more floor space than the Empire State Building.

6. **Jo-Ann Stores,** a fabric and crafts retailer, agreed to be acquired by an affiliate of buyout firm Leonard Green & Partners for $1.6 billion.

7. **DP World**, the port operator controlled by Dubai, raised $1.5 billion by selling 75 percent of its Australian unit to a division of Citigroup.

8. **Royal DSM,** the Dutch company that is the world's largest maker of vitamins, is paying $1.1 billion for Martek Biosciences, a Maryland maker of nutritional ingredients for baby foods.

9. **Nouriel Roubini**, the New York University economist who predicted the financial crisis, purchased a $5.5 million condo in Manhattan.

10. A 37.5-inch-long replica of the ocean liner the *Lusitania* sold for $194,500, an auction record for a toy boat, at a Sotheby's sale of antique toys and games collected by the late **Malcolm Forbes** and his sons.

CLOCKWISE FROM TOP: CHRIS HONDROS/GETTY IMAGES; ENDLESSIMAGE/PLAINPICTURE/CORBIS; TETRA IMAGES/GETTY IMAGES; SOTHEBY'S/BLOOMBERG; JONATHAN FICKIES/BLOOMBERG


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A charging station for the Nissan Leaf

By Eric Pooley
with David Welch



Charged For Battle

The first serious contenders for a mass-scale electric car are on the road. They've already changed GM and Nissan; will they change the world?

worldmags

Most of the drivers on the 101 Freeway in Marin County, Calif., on this foggy December morning are oblivious to the black snub-nosed car gliding along beside them.

Every so often, however, someone does a double take, gives a thumbs-up, or snaps a cell phone picture, because the car in the next lane is one they've never seen before: a Nissan Leaf, the world's first affordable, mass-produced electric vehicle, or EV.

This particular Leaf happens to be No. 1: The very first sold anywhere. At the wheel is Olivier Chalouhi, who took delivery an hour before amid some impressive hoopla at a Nissan dealership in Petaluma. Now, driving south to San Francisco with Nissan Americas Chairman Carlos Tavares riding shotgun, Chalouhi, a 31-year-old Web entrepreneur, is explaining how he came to be the first person to buy this car. His voice is soft but easy to hear from the backseat because, with no internal combustion engine, the Leaf (nationally about $25,000 after a $7,500 federal tax credit) is eerily quiet, almost as cocoon-like as Nissan's $50,000-plus Infiniti M.

"It all started," Chalouhi says, "when I saw an ad for the Chevy Volt." The Volt, which started shipping to dealers in mid-December, is the Leaf's chief competitor in the green-car sweepstakes. It runs for about 40 miles on an electric charge before a small gasoline engine kicks in to recharge the battery. That gives the Volt more than 350 miles of range—unlike the Leaf, which runs for 60 to 100 miles, varying with weather and terrain and driving style, before needing a recharge that can take 30 minutes to 7 hours, depending on the strength of the charger. The Volt's gasoline engine makes it less attractive to some eco-minded consumers like Chalouhi. "In all the articles I read about the Volt, the Leaf was discussed as well," he says. "As soon as I found out about the Leaf, I forgot about the Volt. The Volt wasn't going to project the image I wanted. It has a tailpipe."

"The Volt is a hybrid," Tavares, 52, says happily from the passenger seat. "A very nice hybrid. But we see it as a transitional vehicle, and we were always of the opinion that we were providing the ultimate destination: 100 percent clean. No emissions. No gasoline. No tailpipe."

The energy chain is more complicated than that—the electricity powering a Leaf may or may not come from low-emission sources—but right now it's time to enjoy the ride. Chalouhi turns off the highway and guns the car up a steep, winding road in the Marin Headlands overlooking San Francisco Bay. The Leaf is surprisingly agile and sure-footed; its electric motor has plenty of pep, and 600 pounds of laminated lithium-ion batteries below the floorboards help it hug the road. Chalouhi is having fun with the tight turns heading into the hills, where Nissan has stationed a media team to capture the moment with some suitably dramatic images. Alas, the Golden Gate Bridge is hiding behind the fog, making the glamour shot impossible, so Chalouhi guides the car back down toward the 101 while a product manager, Paul Hawson, briefs him on the next photo op, at City Hall in San Francisco. "At the end of the ceremony," Hawson says, "you and Mr. Tavares will go to the car and plug in the charger together."

Chalouhi looks worried. "So I'm not going to be charging for long?"

"A short amount of time, yes."

Chalouhi lives 35 miles to the south in Redwood City; the Leaf's sophisticated NAV screen is telling him he has 37 miles left before his battery runs out of juice. The owner of the first mass-produced EV, in other words, is experiencing his very first twinge of what GM marketers have helpfully named "range anxiety."

"So I won't get much charge at City Hall," Chalouhi says.

"You'll get some," Hawson assures him. "You'll get home. We'll make sure you get home."

The psychology of the American car buyer is the biggest roadblock Nissan must get past for the Leaf to become the hit that the company promises it will be. Nissan's chief executive officer, Carlos Ghosn, likes to point out that 95 percent of drivers travel less than 100 miles per day, making the Leaf practical for most. Yet practicality doesn't always translate into peace of mind. A recent study by Synovate Motoresearch showed that 60 percent of 1,600 U.S. consumers surveyed think their gasoline-powered cars are reliable. Only 30 percent of those surveyed think hybrid-electric cars are reliable (even after a decade of virtually trouble-free performance), and only 10 percent think electric cars will be trouble-free. "The main thing holding back electric vehicles is the customer," says John German, a former strategic planner for Honda who is now a program director for the International Council on Clean Transportation, a green think tank in Washington. "It's risk aversion."

Nissan and GM missed the decade-long trend toward gasoline-electric hybrid vehicles—Toyota's Prius dominates that

"My call was the right one," says Nissan's Ghosn of the Leaf



Nissan Americas Chairman Tavares, left, and Leaf owner No. 1, Chalouhi. Below, Chalouhi charges up at San Francisco City Hall.

segment, which still accounts for less than 3 percent of all cars sold in the U.S. When Ghosn joined Nissan as chief operating officer in 1999, the company was flirting with bankruptcy; as CEO starting in 2001 he slashed 60 percent of its research and development projects but kept the costly battery program that led to the Leaf. In 2005 he also became chief executive of Renault, which owns 44.3 percent of Nissan, while Nissan holds 15 percent of Renault. The Renault-Nissan alliance has now spent more than 4 billion euros ($5.2 billion) developing EVs and batteries, according to the company.

Both Nissan and GM began work on their new electric vehicles in 2006, when the rest of the auto industry had more or less given up on EVs after a brief foray in the late 1990s and early 2000s. When Nissan announced its project that year, "Nobody took us seriously," Ghosn, 56, says in a telephone interview. "We had many very ironic comments coming from our competitors about the illusion of the electric car."

The sniping never stopped. Former GM Vice-Chairman Robert A. Lutz, who helped develop the Volt, told Bloomberg News last year that all-electric vehicles were still years away from widespread adoption. "He's rolling the dice," Lutz said of Ghosn's battery-only approach. "I don't see it happening."

Until a next-generation battery emerged with better range at less cost, the industry decided, all-electric vehicles were too limited for the mainstream. (Some investors seem to agree these days. Last week electric car manufacturer Tesla's stock dropped 15 percent on the day the insiders' lock-up period expired.) Everyone remembered the fiasco of the first abortive EV era, from 1996 to 2003, when California required GM and other carmakers to offer the vehicles. The cars were too expensive to be profitable, so the carmakers succeeded in overturning the state mandate, then scrapped the program. In GM's case, the company crushed many of the cars, called EV-1s—a PR nightmare captured in the 2006 documentary *Who Killed the Electric Car?*

Now, says Ghosn, "Everybody is competing for the electric car market. People who don't really have an electric car are saying, 'We have one, too.' Even the hybrids want to look electric, which was not obvious four or five years ago. My call was the right one. It doesn't always work out that way, so you're happy when you're vindicated."



His declaration of victory is a little premature. For one thing, major automakers no longer have a choice about going electric. They have to, largely because of government mandate. California law requires the largest automakers to have low- or no-emissions cars in their fleets by 2012, and the Obama Administration's new fuel economy standards, which raise fleet averages to 35.5 mpg by 2016, a 40 percent improvement over current levels, make having a zero-emissions vehicle a smart way to balance out the gas-guzzlers.

While it's true that more than a dozen electric and plug-in hybrids are slated to go on sale in the next two years—entries from Ford, Honda, Toyota, Mazda, and many more will be on display at the Detroit auto show, which begins on Jan. 10—Nissan is the only major automaker betting so heavily on all-electric technology. GM is hedging, with cars that run on electricity but use a gasoline engine to recharge. Honda has put its R&D muscle into hydrogen fuel-cell technology, which remains prohibitively expensive. (The Honda FCX Clarity hydrogen vehicle is a machine of great beauty, and each one costs Honda more than $100,000 to produce, according to K.G. Duleep, a fuel-cell expert at Virginia-based Energy & Environmental Analysis.) BMW, Volkswagen, and Mercedes-Benz have focused on ultra-efficient diesel engines. Toyota's main EV offering is an incremental play: a plug-in Prius that adds about 15 miles of all-electric range before the hybrid motor takes over.

It remains to be seen whether this flood of supply will meet with sustainable demand. In a report called "Drive Green 2020: More Hope Than Reality," marketing firm J.D. Power and Associates projects that in nine years, battery-electric vehicles like the Leaf will enjoy annual sales of only about 100,000 units in the U.S. and 1.3 million units globally, or about 1.8 percent of the 71 million cars expected to be sold. Another 3.9 mil-

PHOTOGRAPHS BY ROBYN TWOMEY FOR BLOOMBERG BUSINESSWEEK

lion hybrids and plug-in hybrids will be sold worldwide in 2020, the firm estimates, bringing the total electric and hybrid market to about 7 percent. "While most consumers say they want to create a smaller personal carbon footprint," the study says, "research shows this consideration carries relatively low weight in the vehicle purchase decision." Other studies are more bullish; Bloomberg New Energy Finance projects that plug-in cars such as the Leaf and the Volt could make up 9 percent of U.S. sales by 2020 and 22 percent by 2030. Yet after 10 years as the world leader in hybrids, Toyota has never sold more than 187,000 Priuses in the U.S. in a year, about the same amount as the Hyundai Sonata. Prius sales reached that peak in 2007, just before the financial meltdown, and have dropped since then as lower fuel prices have lured Americans back to SUVs.

Now consider Ghosn's projections for the Leaf. Nissan will produce only about 50,000 this year and next, but by the end of 2012 three new Leaf plants will be operating—in Oppama, Japan; Sunderland, England; and Smyrna, Tenn.—with a total capacity of 500,000 cars per year and the ability to scale up to a million, just as all those competing EVs and hybrids from Toyota and Audi and Ford will be coming to market. Ghosn is the first to admit that he's making a huge bet.

It may not be an altogether crazy one. Tom Turrentine is director of the Plug-in Hybrid Electric Vehicle Research Center at the University of California, Davis. An anthropologist by training, Turrentine has partnered with major automakers to conduct a series of detailed studies of actual Americans driving actual electric cars—not just EV enthusiasts, but regular people driving an array of electrics. As his team observed the driving habits of more than 300 EV households over the past several years, families driving and living with their electrified Minis, plug-in Priuses, and Nissan hyperminis, the data told him that EVs "were never going to be 'just like' internal combustion cars." They were different, and in some ways superior.


On display at the Geneva auto show in 2010, a Leaf chassis

"There's something about electric drive, with its quiet glide and immediately available torque, that drivers really enjoy. Even when they aren't going fast, people think they are having fun," says Turrentine. "Engineers at BMW tell me it's the way the cars accelerate. You don't have clutches and transmissions, so your accelerator pedal is feeding electricity directly to the motor, and you feel it accelerate the car. There's nothing in between you and the tires. Some people fall in love with that feeling."

For all his confidence, Ghosn understands the immense challenges to expanding Leaf sales. That's why, for the past three years, his company has had a team of traveling executives—the Zero Emission Mobility Team—meeting with city, state, and utility officials around the country to solve crucial infrastructure problems such as the cumbersome permitting process for home chargers and the need to create a network of high-speed public chargers in cities and along interstate highways. "We are not the provider of just a car this time," he says. "We are the provider of a whole new system."


At the 2008 Volt unveiling in Detroit, a media frenzy

Utilities may welcome the opportunity to sell more electricity, but they also worry about the load. Several new EVs suddenly plugged into the same suburban block could fry a local transformer. More difficult is installing the needed network of charging stations, both in the home and in public, to allay range anxiety; 13,000 public chargers are expected to be in the ground by the end of 2011. (The U.S., by Nissan's count, has 106,000 gas stations coast to coast.)

The most important issue of all has to do with customer education and acceptance. To appeal to the "pragmatic majority" of buyers, Nissan needs to sell the cost advantage of ownership: year in and year out, EVs cost far less to own and operate than internal-combustion vehicles—about 2¢ per mile to drive, compared with about 13¢ per mile for an average gasoline-powered car, according to Nissan—and less to maintain as well. To buy Leafs in serious numbers, these pragmatic men and women need to be able to imagine themselves behind the wheel of an electric vehicle.

For the product to be competitive, however, Nissan must also keep the price down. Nissan manufactures its own batteries in a joint venture with NEC, and they account for roughly half the cost of the car, making the initial price of an EV more than that of comparable gas-powered vehicles. For now, federal and state tax credits and rebates are required to make the cars cost competitive. The Leaf's sticker price of about $33,000 makes it $10,000 costlier than a well-equipped Honda Civic, for example. Factor in the $7,500 federal tax credit (along with rebates and tax credits available in 16 states, such as a $5,000 price break in California and a $4,500 rebate in Hawaii), and the EV becomes competitive. Assuming the new Congress doesn't roll it back, that federal tax credit is available to the first 200,000 EV customers of each carmaker; when it runs out, Nissan expects to be selling so many Leafs that economies of scale will bring costs down. Ghosn says the company needs to sell between 500,000 and 1 million Leafs a year in order to enjoy those economies. "Then we'll be able to compete without any government subsidies. Our battery costs are already coming way, way down. Everybody in the business has estimates, but nobody really knows everything we're up to. The Leaf is going to be one of the most profitable products Nissan has ever made."

While Ghosn was planning the Leaf in 2006, Bob Lutz and Jon Lauckner, GM's vice-chairman and director of product planning at the time, were also trying to dream up an electric car that would leapfrog the Prius. Like Nissan, GM was after some much needed public acclaim and green credibility. The company had been derided for shutting down its EV-1 and crushing the cars, and Lutz thought a pure EV that used no gasoline would be a public relations coup.

Lauckner, now president of General Motors Ventures, the automaker's technology venture capital group, studied American

BLOOMBERG (3)

"We wanted this to be someone's first car," says a Volt designer

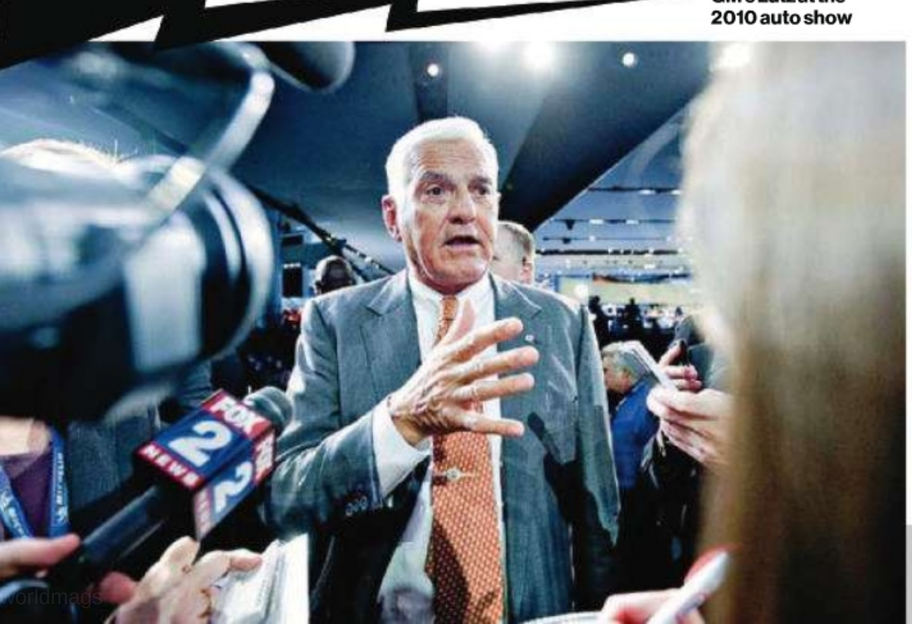
driving habits just as Ghosn and Tavares were doing at Nissan. Where the Nissan team focused on the fewer than 100 miles a day traveled by 95 percent of drivers, Lauckner lingered over another set of numbers: 78 percent drive fewer than 40 miles a day. He figured a car equipped with enough battery power to go that far, plus a gasoline engine to recharge it on the fly, "would be a game-changing concept that would address the shortfalls of electric vehicles on one side and go beyond the top hybrids on the other. We wanted this to be someone's first car, not their second or third commuter car," he says.

Lauckner showed Lutz a schematic for the Chevy Volt, a car that would allow many drivers to forget about gasoline unless they were taking a special trip. Someone with a 30-mile commute would get roughly 150 miles per gallon, and the car would travel well over 300 miles on a tank of gas. (The EPA, using a new metric designed to compare different fuel types, now estimates the Volt's average fuel economy at 93 "mpg equivalent" in electric mode, 37 in gas-only. The Leaf's mpg equivalent is 99.) Later that summer, they took the proposal to then-CEO Rick Wagoner, who had killed GM's EV-1 after $1 billion in investments because he was convinced consumers didn't want it. Wagoner bought into the idea.

Once Wagoner and GM's board approved, engineers had to build the thing. Getting beyond the early adopters and selling to the general public meant GM needed to offer more than just fuel economy, especially since the Volt was going to list at more than $40,000 before tax credits. The car had to be upscale, says Tony Posawatz, the Volt's vehicle line director, but it wasn't going to be a luxury vehicle.

In his small office deep inside GM's Vehicle Engineering Center in suburban Detroit, Posawatz pulls out some books on the history of electric vehicles, which date back to 1881 and outsold gasoline-powered cars in the early days. Henry Ford's wife drove one. Posawatz points to a 1910 ad for the Baker Electric. Beneath a drawing of a woman at the wheel, the ad copy boasts of the "quietest and most refined electric car." Back then, he says, electric carmakers like Baker, Detroit Electric, and Waverly Electric targeted women, who wouldn't have to crank a starter or tolerate the noise and soot of gas-powered cars.

No one has to crank a car anymore, but electric cars are still quiet and clean. That meant that even if the Volt wasn't going to be a luxury car, it could be premium in many ways. A near-silent ride would be a selling point. Like Nissan's engineers, Posawatz knew that when you get rid of a car's exhaust note, the vehicle is so quiet that passengers get a bigger dose of road and wind noise. In conventional cars, "the gasoline engine masks a lot of your sins," Posawatz says. The engineers worked to tighten the gaps between doors and body panels to reduce wind noise, then packed the car with sound-deadening material to hide the growl of the gasoline engine when it's running. GM also engineered a body that is stiffer than most luxury cars to give it a smoother ride and more precise handling, something the hybrids on the market traditionally do not offer. With 80 percent high-strength steel and a buttoned-up body, the Volt is as stiff as most luxury sports cars, built to handle hairpin turns. It drives as well or better than a Leaf. One thing is certain: Neither will ever be mistaken for a golf cart.



GM's Lutz at the 2010 auto show

In the spring of 2008, more than two and a half years before the Leaf would go on sale and a year before Ghosn showed it off in public for the first time, Nissan gathered executives from governmental affairs, product planning, communications, sales, and marketing, to create its Zero Emission Mobility Team. The team had a huge job: Prepare America for the EV by creating Leaf-friendly policies in states with progressive environmental agendas, partnering with local officials and utilities to encourage tax incentives, and streamlining the permitting and installation process for home chargers while building a network of public charging stations and educating drivers about the advantages of EVs. Doing all of that meant the carmaker would have to establish relationships with a range of players it hadn't dealt with before. And it meant Nissan would have to insert itself, for the first time, between its dealers and their customers.

"We've never had to organize anything like this," says Brian Carolin, Nissan's senior vice-president for sales and marketing. "I know how to sell cars, and after 26 years with this company, I like to think I understand American psychology. But this is the most interesting and demanding car launch I've ever been involved with. I have a portfolio of 17 Nissan nameplates, half a dozen Infinitis, and one Leaf. I spend a wildly disproportionate amount of my time on the Leaf."

The Mobility Team had two skillful players: executives Tracy Woodard (from government affairs) and Mark Perry (from product development), who toured the country together meeting with activists and officials, figuring out which markets to sell into first. They sorted potential launch markets according to three main criteria. First, they looked for places that had EV incentives left over from the late 1990s-early 2000s. Then they pored over maps showing the density of hybrid customers. (Of the early Leaf buyers, 80 percent have never

owned a Nissan before. Amost half have owned Priuses.) Third, they focused on states where the local utilities were comfortable with the idea and willing to upgrade their grids if needed.

In the end, they came up with a Wave One map that included Washington, Oregon, California, Arizona, Tennessee, Texas, and Hawaii. (Wave Two will follow in the late summer and early fall 2011, continuing around the Sunbelt and then up the East Coast.) By limiting early sales to just seven states, Nissan could help achieve a critical mass of charging stations. Of the 13,000 stations expected nationwide by the end of 2011, almost half will be on the West Coast. Limiting the market also means Nissan will have to train, initially, only 163 of its 1,000 U.S. dealers to sell and service the car.

In the summer of 2008, Woodard, 45, and Perry, 53, began reaching out to "conveners," influential local officials and activists who could bring together groups of stakeholders. In the fall, they held their first major meeting in San Francisco, organized by Jack P. Broadbent, CEO of the Bay Area Air Quality Management District. "Nissan did this right," says Broadbent. "They got here six months before the competition, and they broke through the lingering suspicion of the activists." They invited EV evangelists such as Paul Scott to Yokohama to drive the Leaf on Nissan's test track there. Scott, vice-president of the EV activist group Plug-In America, then blogged happily about the experience. Nissan donated $25,000 to Plug-in America as well, says Scott, who now sells Leafs at Santa Monica Nissan. "We're not bought off," he adds. "What won us over is the fact that they're making this EV."

As Woodard and Perry met more people, they categorized their local partners into personality types: "bandleaders," "trailbosses," "cat-herders." What they had in common, Woodard says, was that "they know everybody. And when they invite people to meetings, the people come." Not long ago, Woodward counted up the business cards she had collected from stakeholder meetings: 1,400 people in 307 cities in 27 states. "It's a very hands-on, personal thing," she says. "And we surprised them, because this time, unlike regular lobbying, the ask isn't for the company. The ask is for the customer: Give the EV buyer incentives. Set up EV charging systems. Streamline the permitting process for home chargers."

There were plenty of cities where the local leaders looked at Woodard and Perry as if they each had six heads, but mostly there was enthusiasm, even impatience. Perry came across a local news article announcing that Portland General Electric was installing 100 charging stations, and Nissan hadn't even visited Portland yet. "What are they doing?" he asked Woodard. "There's nothing to charge!"

"They're getting ready for us," Woodard replied.

While traveling the country, Woodard and Perry began to hear footsteps. "We almost thought there was a bug in our luggage," Woodard says, "because after we'd leave a town, there'd be another visitor coming right behind." Usually it was Britta Gross, GM's director of global systems and infrastructure, paving the way for the Volt. Sometimes it was an executive from Ford, or Mitsubishi, or Toyota. "That was fine, because we were saying about 80 percent the same things," Woodard says. "Leaf is more dependent on electric charging than Volt, but we were all talking about infrastructure, planning, permits, and charging installation. It gives credibility and scale.

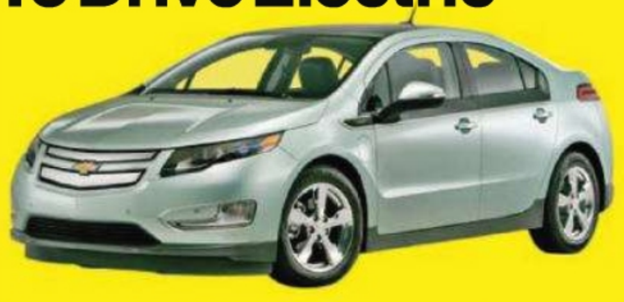
Cracker Barrel announced it will install chargers at 24 locations in Tennessee

It helps if cities know there's a lot of interest."

Charging an electric car with a standard 120-volt outlet can take up to 18 hours. You need six to eight hours to charge one with a more powerful 240-volt outlet. Buying one today means contacting a utility to see if the neighborhood transformer can handle the load, getting a contractor to install a 240-volt charger in your garage, and having the city inspect it. It can cost anywhere from a few hundred dollars to $3,000 and take a month or two, says Ed Kjaer, director of plug-in vehicle readiness for power utility Southern California Edison, which has had electric cars in its company fleet since 1998.

Nissan, and to a lesser extent GM, needed to make the process easier for both customers and utilities. So the company hired a contractor, Monrovia (Calif.)-based AeroVironment, to help Leaf buyers with the installation process. Woodard and Perry also cut deals with local utilities: If Nissan sold a Leaf in a utility's territory, they agreed, with the permission of the customer, to let the utility know. As Woodard and Perry discovered, "there are 3,000 utilities in the U.S., with 3,000 stories," says Perry. "So this is a regional issue. In Houston, with massive homes and AC loads, adding an EV is no big deal. A San Francisco row house will have a much smaller load." An electric vehicle charging at 240 volts draws 3,300 watts of power. A hair dryer may draw 1,600. "So we're two hair

Three Ways To Drive Electric



Chevy Volt

Approach	Pros	Cons
149-hp electric drive unit runs 40 miles on a charge, then an 80-hp gas engine recharges battery.	Great acceleration and handling. No "range anxiety." Goes 350+ miles on a tank of gasoline.	Uses gasoline. In gas mode, averages a modest 37 mpg; tailpipe lowers green cred.

dryers," says Perry. "If that will cause a neighborhood transformer to blow, you've got bigger problems than EVs. To Portland General Electric, we were like three plasma TVs. To NRG in Houston, we were a mosquito. Our message was, 'We're coming, and we don't want to be your pain point, but you need to get ready.' "

Soon they were giving presentations at utility conferences, places where car companies had never showed up before. And before long Southern California Edison was setting up a booth at the Los Angeles auto show. "We'd been speaking two different languages," says Perry, "but gradually we learned to communicate. The breakthrough came when they started calling us 'an appliance.' As car guys, we freaked over that. But it meant we were accepted."

Part of what makes the emerging EV economy so intriguing is the large number of unknowns. How will EV drivers choose to charge their vehicles? The best guess of industry executives is that 80 percent of charging will take place at home. Public chargers may be no more than a security blanket, but already retailers are lining up to offer them. In Tennessee, the Cracker Barrel restaurant chain recently announced that it would install chargers at 24 of its interstate locations, part of an intercity network that will link Nashville, Chattanooga, and Knoxville. (It's a return to the company's roots: When the first Cracker Barrel opened in 1969, it sold both food and gas.) No one yet knows how Cracker Barrel or other retailers will monetize these charges. They can't sell electricity directly to customers—in most states, only utilities and merchant generators can do that—but they could charge for a half-hour in the parking space next to the charger.

There are other open questions. Will customers happily pay for flat-fee, unlimited-use charging plans such as the one NRG is rolling out in Houston? Or will they prefer to buy their charges à la carte, for a service fee similar to the one at an ATM? Will higher prices stop "opportunity chargers" who top up their EVs after work, even if they don't really need the charge to get home? Or will people pay any price because they want the peace of mind an afternoon charge can bring? What does that market look like? Is it different by hour of the day, by demographics? Nobody knows.

Inside the green car community—the world of academics, analysts, policymakers, and environmentalists who spend their days worrying about transportation emissions—there's also a lively debate about which kind of low-emissions car is greenest. The Leaf produces zero emissions, and according to numerous studies touted by Nissan, even if the electricity that powers it comes from a coal-fired plant, its carbon footprint is smaller than that of an average gasoline-powered car. If its electricity comes from solar, wind, hydro or nuclear power, then the Leaf is an unassailably zero-emission vehicle. And Nissan executives rightly point out that U.S. electric generation is getting cleaner. (A Volt's true emissions are even harder to determine, since it can be driven in all-electric mode or with a gasoline assist.)

For now, the heavy batteries that store the power in Leafs and Volts are still too expensive to be the most cost-effective option, according to a 2009 study by engineers at Carnegie-Mellon University. The study also found that plug-in EVs with 40 or more miles of all-electric range "do not offer the lowest lifetime cost in any scenario, although they could minimize greenhouse gas emissions." Lighter plug-in hybrids with about 10 miles of all-electric range appear to offer the best mix of price, charging time, and efficiency, according to Jeremy Michalek, the Carnegie Mellon professor who led the study. Plug-ins of this sort (the Prius, due in 2012, will be one) work best for urban drivers who can charge every 20 miles or



Nissan Leaf

Approach	Pros	Cons
Pure all-battery electric, no gas backup.	Great acceleration and handling. No tailpipe, zero emissions. Up to 100 miles per charge.	Limited range. Running heater or A/C sucks power. Few public chargers for now.

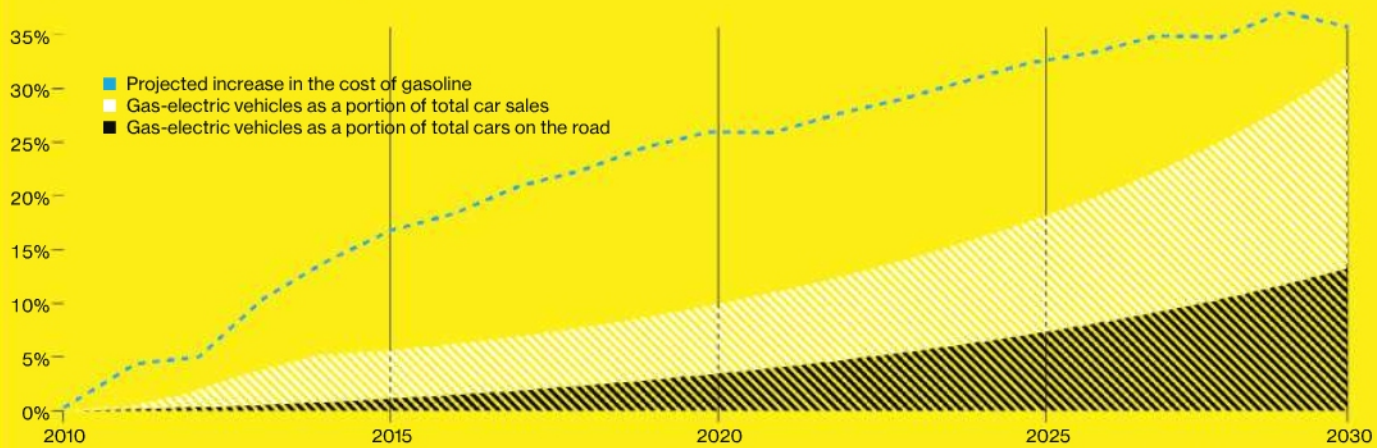


Toyota Prius Plug-In

Approach	Pros	Cons
Drives 10 to 15 miles on a charge before gasoline-electric hybrid system kicks in.	Small battery weighs and costs less. Most cost-effective approach for next five years.	Requires frequent charging to produce best mileage and enviro benefit. Not available until 2012.

Plugging in, Percent by Percent

Even if bullish projections turn out to be true, electric vehicles will represent a small portion of cars on the road for decades to come



DATA: U.S. ENERGY INFORMATION ADMINISTRATION, PTRM

so, he says. All of these plug-in cars, of course, are far cleaner and cheaper to operate than what most Americans drive now.

In August 2009, Ghosn unveiled the Leaf at a ceremony dedicating Nissan's new headquarters in Yokohama. That same month, Nissan opened a Leaf website and asked visitors to register if they wanted to learn more. Within a year they had 175,000 "hand-raisers" without running a single TV spot for the car. The number has since risen to more than 250,000.

It didn't cost a cent to register, and rivals downplay the hand-raisers' significance. Nissan says it has used them to bring some 50,000 people to Leaf test drives around the country and for surveys and focus groups. On Apr. 20, 2010, a month after the company announced pricing for the vehicle, it invited the hand-raisers to make an online "reservation" by putting down a refundable $99 fee. They got 6,000 reservations in the first 24 hours and 20,000 within five months, three months ahead of schedule. Now that the company is inviting small groups of those who reserved to contact a dealer and order a Leaf, about half of them are actually ordering a car. The ones who don't order now can still do it when and if they are ready.

Complexity and cost have alienated at least one prospective Leaf buyer. Kenneth Shiels, a 64-year-old retired schoolteacher in El Granada, Calif., put down a $99 deposit for a Leaf on Apr. 20. He owns a Prius and a 2000 Honda Insight, the first hybrid on the market, and was dying to get into an EV. Nissan contacted him in August, inviting him to pay $100 to AeroVironment in exchange for an inspection of his electrical wiring and an estimate of the charger's installation cost.

Shiels didn't go for it. He guesstimated that the installation would set him back about $2,400. He added that to the $3,190 in sales tax he would pay on the $33,720 Leaf LS, and figured he was spending close to $40,000 before the federal government's $7,500 tax credit and California's $5,000 rebate brought the price back down. "I'm losing interest," he says. "I was excited, but I think I'll pull out of this. I felt like the initial price I saw in April was a come-on, and then it went sky-high."

Nissan says it's delighted by consumer demand for the car, demand so strong it can't make enough Leafs until 2012. (There are no demos to be found at Nissan dealers; every Leaf made is going to paying customers, because Nissan believes word of mouth will be the most powerful seller.) Customers allowed to order a Leaf can expect to wait four to seven months for it to be built to specifications. More than 2,500 Americans have now bought the car and will take delivery in coming months. Additional waves of U.S. buyers will be invited to order cars until some 20,000 have been sold by the end of 2011. If you get to order one in the spring, you'll see a Leaf in your driveway by the fall.

Few doubt that in the next year or two Nissan will be able to sell the 50,000 Leafs it can produce globally. As production ramps up to 10 times that, however, Nissan will need to draw customers from beyond the circle of green enthusiasts. If gasoline prices rise and the Leaf proves to be reliable and delivers its promised range at a fraction of the cost of gasoline-powered cars, Nissan might just pull it off. When mainstream pragmatists test the waters, however, they may be tempted to do so with a vehicle that uses a conventional gasoline-powered engine to augment its electric range. They may opt for a plug-in Prius. GM thinks they'll choose the Volt. Nissan is simply happy that so much of the EV conversation now revolves around Nissan.

"We want people to be talking about Nissan as the brand that brought this car to the masses," says Carolin, the company's marketing boss. "The big prize for me is not how many Leafs I sell. It is, 'How can I use the Leaf to build and improve the Nissan brand?' I've worked for the company for many years, and we've never had a single point of focus. The lack of focus of this brand has been an issue globally. The gift of the Leaf is that it gives precision to what we stand for. Now we have a message. We stand for innovation." The little snub-nosed car may be the start of something big. *—With Alan Ohnsman*

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STEPHEN JENNINGS' RUSSIAN INVESTMENT BANK RENAISSANCE CAPITAL HAS ENDURED TWO NEAR-DEATH EXPERIENCES IN A DOZEN YEARS. NOW HE'S TAKING A BIG RISK IN AFRICA.

Moscow Survivor

BY CAROL MATLACK

PHOTOGRAPHS BY ANNA SKLADMANN

Jennings oversees his investment bank from his office overlooking the Moscow River

worldmags

Stephen Jennings, the co-founder and chief executive officer of the Russian investment bank Renaissance Capital, is far from his adopted home in Moscow. Sitting on a throne-like dais, the black, red, and green Kenyan flag draped behind him, Jennings presides over the launch of Tatu City, a planned community for 60,000 northeast of Nairobi. Renaissance has already spent $100 million of its own cash on land and planning. "We've never been involved in a project that has excited and inspired me more," Jennings tells an audience of Kenyan officials and business leaders in his broad New Zealand twang.

Constructing a city from scratch in such a dicey market might seem like a reach for a bank that has barely survived two near-death experiences in only 12 years. Kenya ranks among the world's worst countries in an annual corruption index compiled by the advocacy group Transparency International–154th out of 178. For Jennings, this kind of gamble is business as usual: part of a risky and expensive push into brokerage, investment banking, and real estate across sub-Saharan Africa. That strategy fits into his larger ambition of making Renaissance a financial powerhouse in emerging markets worldwide.

Vimal Shah, a Kenyan co-investor in Tatu City, calls Jennings "a believer." The owner of an oilseed refining business, Shah recalls a 2007 helicopter ride over the Tatu site, now a coffee plantation. Looking south at the sprawling slums of Nairobi and the traffic-choked roads surrounding the capital, the Renaissance CEO "understood instantly" the potential appeal to the Kenyan business class of a gleaming suburb with its own complex of modern residences and office buildings, says Shah. "He said, 'Done. Let's do it.' "

Tempering his boldness, Jennings, 50, has demonstrated a canny pragmatism when protecting his interests back in Russia. He understands and observes Moscow's murky and sometimes rough local rules. After Vladimir Putin, a former KGB officer, was elected President in 2000, Jennings hired several executives with connections to the Kremlin and the Russian intelligence service, now known as the FSB. Renaissance has generally avoided run-ins with the government, even if that requires sacrificing an investment opportunity. In Africa, Jennings once again will have to balance his appetite for risk against the hazards of doing business in a volatile environment.

The Taranaki peninsula, where Jennings grew up on a farm, is "the boonies, even by New Zealand standards," he says. An avid rugby player, he excelled at school and landed a spot in a prestigious economics program at the University of Auckland. From there he went to work for New Zealand's Treasury Dept. during a period of tax cuts and privatization. A subsequent job with Credit Suisse First Boston took him to Moscow for what was supposed to be a six-week consulting assignment.

Boris Yeltsin's government had hired Western investment banks to help privatize the post-Soviet economy. Jennings, who didn't know any Russian, was paired with fellow Credit Suisse banker Boris Jordan, the American grandson of Soviet émigrés and a fluent speaker. They set up shop in the art nouveau Metropol Hotel, across from the Bolshoi Theater, and hired 300 students from Moscow State University as temporary staff. Jennings, then 32, and Jordan, 27, soon spotted a lucrative opportunity.

The Yeltsin government had issued vouchers that citizens could use to acquire shares in state-run businesses. Many Russians wanted quick cash instead. Lacking rubber bands, they bundled the vouchers with cut-up condoms and brought them to Credit Suisse, which bought and resold the certificates at a fat profit. Jennings and Jordan then decided they could make more money buying undervalued Russian assets themselves. In early 1995, they quit Credit Suisse and started Renaissance Capital.

They were an incongruous pair. Baby-faced, gregarious Jordan hobnobbed with politicians and journalists. Lanky, no-nonsense Jennings quietly ran the business. By 1998, Renaissance was raking in $150 million in annual profits. In June of that year, the co-founders held a client conference that featured a party at the pastel-pink-and-white Kuskovo Palace near Moscow. Hundreds of guests strolled through gilded drawing rooms, sipping premium champagne and grazing on caviar and lobster. Bolshoi dancers pirouetted on a stage while a team of jet-skiers zoomed though flaming hoops on an adjacent lake. "Boris and Stephen, God bless them–it was over the top," recalls Robert P. Smith, a Boston-based investor who attended the gala.

Ten weeks later, Jennings woke at 3 a.m. to find a haggard Jordan at the door of his Moscow apartment. Jordan had come from the Russian White House, where leaders were holding emergency economic talks. He had learned that



ON THE WAY UP, RENAISSANCE HELD A PARTY AT A PALACE NEAR MOSCOW THAT FEATURED BOLSHOI DANCERS AND ACROBATIC JET-SKIERS

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Former partner Jordan's fluent Russian and facility at hobnobbing with politicians and journalists helped Renaissance gain its footing

Russia would devalue the ruble and default on its immense sovereign debt. Renaissance was owed hundreds of millions of dollars by clients that were suddenly insolvent.

"Boris," Jennings told his partner, "we're broke."

Renaissance had five shareholders. Their holdings now worthless, Jordan and three of the others quit and moved on to other pursuits. Jennings says he never considered following suit—"not for one second."

Goldman Sachs and other competitors took the 1998 debt crisis as a signal to flee Moscow. Renaissance shrank, but it endured. Within a few years, Jennings had the company humming again, fueled by a Russian oil and gas boom. He branched out from investment banking to private equity and consumer lending. Renaissance moved into a skyscraper overlooking the Moscow River and recruited executives from bigger banks. "It was a place that a lot of people aspired to be," recalls Robert Foresman, whom Jennings hired away from Dresdner Kleinwort Wasserstein in 2006. "The buzz in the place and the atmosphere and tempo were at a different level than at a global bank," says Foresman, who now heads the Russian operations of Barclays Bank. Jennings bought himself a Gulfstream jet, a vacation spread in New Zealand, and a British country estate in Oxfordshire.

Then, in September 2008, it all came tumbling down again. As the global credit crunch hit Russia, Renaissance's sources of short-term loans dried up. Jordan was on a weekend fishing trip near the Volga River city of Tver when he received a cell phone call from his former partner. "All his [credit] lines were cut overnight," says Jordan, who now runs Sputnik Group, a Moscow-based fund manager. "He had to deliver money to his clients, and he had no lines to do it. He needed to close a deal by Monday to save the bank. He asked me if I would buy some equity to come back in."

Jordan rushed back to Moscow only to discover that Jennings had already found an emergency source of cash: Mikhail Prokhorov, a Russian billionaire with holdings in mining and other industries. On Sept. 22, Renaissance announced that Prokhorov, best known in the U.S. as the co-owner of the New Jersey Nets basketball team, would pay $500 million for 50 percent of Renaissance, minus one share. The deal left control in Jennings' hands but underscored the bank's weakened condition. Prokhorov's investment valued it at $1 billion; in 2007, according to Russian press reports, Renaissance had rejected an offer by state-controlled bank VTB to buy it for as much as $4 billion. Jennings unloaded his Gulfstream and got rid of most of the bank's top executives, along with almost half of the 1,400-person staff.

As Jennings rebuilds, he's aiming higher than ever. The scenario he sketches assumes that the U.S. and Europe will play a diminishing role in the global economy. They will be outpaced not only by China, Brazil, and India, he predicts, but also by tiny but fast-growing economies such as Zambia, Bangladesh, and Guyana. More and more of the investment powering this growth, he reckons, will originate in emerging markets, bypassing New York and London. Who better than Renaissance, battle-hardened in Moscow, to play dealmaker?

Renaissance has handled transactions worth nearly $14 billion in 20 emerging markets over the past year. These range from the $2.2 billion Hong Kong listing of Russian aluminum group Rusal to the $955 million sale of Central African Mining and Exploration to Kazakhstan-based Eurasian Natural Resources. Some 25 percent of the bank's revenue comes from Africa. "The world is designed for us right now," Jennings tells his 16 Nairobi employees over a lunch of steak and salad on the trading floor of Renaissance's offices in the Kenyan capital.

Skeptics say Jennings could be overreaching—again. Even after Prokhorov's cash infusion, Renaissance is fighting to regain its financial health. The bank posted a $3 million pretax loss during the first half of 2010, after eking out a $12.7 million full-year profit in 2009. Moody's Investors Service and other rating agencies are raising questions about the $800 million that the bank has lent to affiliated businesses, an amount equivalent to 75 percent of its total equity at the end of 2009. Much of that has been used to finance the expansion

in Africa. Before investing in Renaissance, Prokhorov insisted that the bank strictly limit such lending in the future. In a Dec. 8 interview with Bloomberg Television, Prokhorov said he is happy with his investment in the bank, which he estimated has doubled in value since 2008.

Investment bankers in sub-Saharan Africa face daunting obstacles, including political instability, weak legal protections, and rampant corruption, says Christopher Palmer, head of global emerging markets at Gartmore Investment Management in London. Even in countries considered relatively investor-friendly, such as Uganda, governments have abruptly "reinterpreted" deals, Palmer says. "There are not only challenges to making a deal ... but will the deal stick? The business environment is more challenging than Eastern Europe or South Asia, and far more challenging than Latin America or the Far East."

Jennings contends that Renaissance's experience in Russia's chaotic markets

JENNINGS' AFRICAN BET FACES TOUGH OBSTACLES, INCLUDING CORRUPTION AND POLITICAL INSTABILITY

gives it an edge. The bank has largely avoided clashes with Russian officialdom—no small feat in a country where businesses are periodically targeted with dubious investigations that, executives complain, amount to shakedowns or asset grabs. "It's much less of an issue for us than people might think," Jennings says. Russian officials, he says, respect his bank because "we've promoted Russia, we helped open capital markets." Asked whom he admires in Russia, Jennings immediately mentions Putin: "I respect what Putin has done to consolidate power. I don't agree with everything he's done, but Russia was getting into a very anarchic situation."

In 2005, Renaissance led a group of investors that outbid oligarch Viktor Vekselberg for VSMPO-Avisma, a Russian company that is the world's biggest titanium producer, supplying the likes of Boeing and Airbus. The following year, the Kremlin made it known that it wanted control of the titanium group. Renaissance agreed to sell its stake for an undisclosed sum to the government's military export company, Rosoboronexport. Jennings said at the time that he didn't want to pick a fight with the Kremlin. Renaissance says on its website that it realized a "strong return" on the deal.

Renaissance chose to walk away from another potential confrontation after learning that two of its former subsidiaries had been involved in an alleged scheme to obtain $107 million in fraudulent tax refunds from the Russian government. The purported fraud took place in 2006, shortly after the bank had sold the subsidiaries. Renaissance says it was not involved in the affair and did nothing wrong. Hans Jochum Horn, a deputy chief executive, says that when the bank learned about the fraud allegations, it decided not to alert the authorities because "we did not suffer any losses, nor did any of our clients."

The incident came to light after Hermitage Capital Management, a London-based fund that had been a leading investor in Russia, complained publicly that some of its subsidiaries had been enmeshed in a similar tax refund episode. In a court filing in New York in 2009, Hermitage said that after discovering abuse of its units in 2007, CEO William Browder received a call from Igor Sagiryan, then Renaissance's president. Sagiryan offered to help Hermitage liquidate its subsidiaries, a step that would have made it difficult to track the perpetrators of the alleged tax fraud, according to the filing. Hermitage learned later that the two former Renaissance subsidiaries had been involved in a similar scheme and then were liquidated, the filing said.

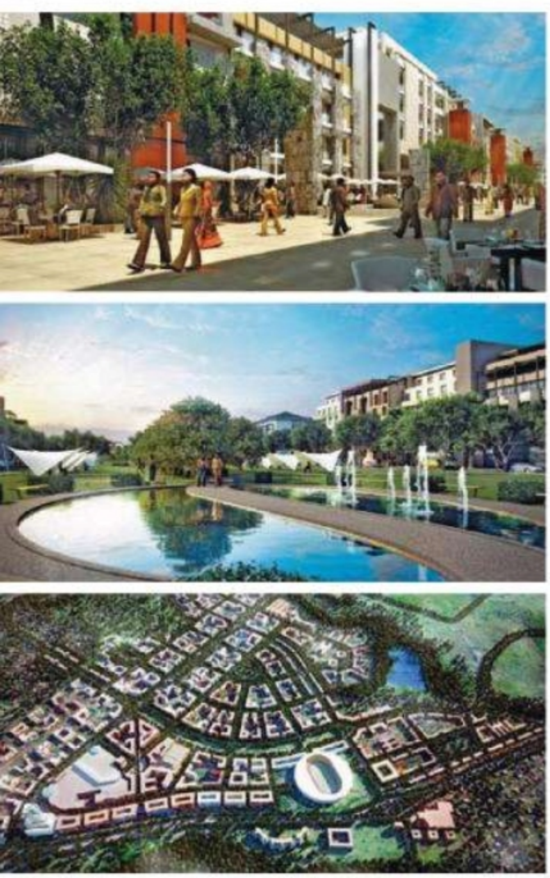
Renaissance's Horn says Sagiryan, who no longer works for the bank, was not authorized to contact Hermitage. Horn says he doesn't know what Sagiryan said to Browder. Sagiryan did not respond to interview requests, and Browder declined to comment for this article.

Apart from the dangers posed by Moscow's fraud artists, Renaissance faces other challenges in Russia. State-controlled VTB is pushing into the brokerage business, overtaking Renaissance as this year's top underwriter, with a 12.3 percent share of Russian stock sales, according to data compiled by Bloomberg. VTB and other local rivals are poaching Renaissance's talent, including, in recent weeks, its chief strategist and top oil analyst.

Against that backdrop, growth in Africa looks even more attractive to Jennings. As the sun sets in Nairobi, he pulls out his BlackBerry and clicks on an e-mail from Clifford Sacks, his African equities chief. The bank, Sacks reports, has been chosen to handle the initial public offering of a Nigerian cement company.

Grinning broadly, Jennings reads the note aloud: "Typically Renaissance. We started behind the pack. Elbowed, scrapped, kicked our way to the front. This was a great performance of which we can be proud." B

An artist's conception of Renaissance's Tatu City in Kenya



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UP IN THE AIR

Will Richard Branson's Virgin America fly?

Branson at Dallas Fort Worth airport, awaiting the arrival of the first Virgin America flight to Dallas

By Brad Stone Photographs by Alex Tehrani



ON A SUNNY, WIND-SWEPT DECEMBER MORNING,

Virgin America kicked off a day of festivities along the otherwise unfestive runways of Dallas Fort Worth Airport. Four longhorn cattle lolled in a pen while dignitaries such as Dallas Mayor Tom Leppert lunched on pulled pork and ribs, and lasso artists twirled rope. The main attraction was the host, 60-year-old Sir Richard Branson, billionaire bon vivant and founder of the Virgin Group. While he was at the center of the celebration, he was also making an incursion into enemy territory.

The enemy, American Airlines, dominates air traffic at DFW. The 80-year-old airline and its affiliates send about 765 flights out of Dallas every day, making up more than 85 percent of traffic at the nation's fourth-busiest airport. Tiny Virgin America—with its 36 planes and 1,700 employees—was initiating just four daily flights, two each to Los Angeles and San Francisco. Branson, in cowboy boots, chaps, and carrying a cowboy hat that he looked reluctant to don over his golden locks, was undaunted by the taxiing AA jets that crawled past the party like Panzers on patrol. "You now have a choice," Branson told a crowd of around 200 employees, local politicians, and press. "You can either go on that other carrier and get their kind of service and get treated a little bit like those animals over there"—he said, gesturing to the cattle—"or you can come on the Virgin carrier and you can have a blast."

Over the last three years, Virgin America's philosophy of fun in the skies has shown promise, despite byzantine regulations, powerful competitors, and the ever-present fact that airlines, as a whole, tend to hemorrhage money during recessions and spikes in fuel prices. But the airline is at a turning point, and its future is far from certain.

Virgin America offers an alternative to the often cramped, tedious experience of flying on a so-called legacy airline. Its Airbus A319 and A320 jets are relatively new, there's in-flight entertainment in every seat-back, and Wi-Fi Internet access on every plane. As a result, Virgin has collected a passel of best-domestic-airline awards over the last three years from publications such as *Condé Nast Traveler* and *Zagat*, and has built a devoted following among circles such as the West Coast tech industry. "It's clean, it's new, the music makes you happy, and the mood lighting makes you calm. It's just better," says Jason Hirschhorn, the former co-president of MySpace, who selects Virgin America flights whenever they are available.

Geek love and awards, though, can only get a young airline so far. The skies are a brutally competitive marketplace in which the legacy behemoths corner routes, dominate major airports, and lock in customers with frequent-flier programs. Since deregulation of the airline industry in 1978, more than 100 small airline startups have come and gone. JetBlue is among the very few to have survived.

In November, Virgin America announced its first quarterly profit, of $7.5 million, on $202 million in revenues, but it lost $22.5 million over the first half of the year and has lost $400 million or more since its founding in 2004. David Cush, Virgin America's CEO and a former American Airlines executive, promises the airline will turn an overall profit in 2011.

Virgin America's small profit seems less hopeful in light of the extremely positive environment for airlines. With oil prices well off their 2008 highs and American travelers enthusiastically flying again despite the groping hands of TSA agents, the entire domestic airline industry is in one of those hearty periods when it makes good money. The Bloomberg U.S. Airlines Index, of 12 U.S. carriers, climbed 22 percent in 2010. "They've created a niche, but I don't think it's sustainable," says Mo Garfinkle, chief executive officer of GCW, an aviation consulting firm. "If something happens—and something always seems to happen in this industry, whether it's fuel prices or war or SARS—they're in trouble."

Virgin America does have at least part of one big asset: Branson. He is a legendary salesman with a special love of aviation—not only for the business, but for adventures like his attempted around-the-world balloon flights. To hear him talk, profits are almost secondary to his mission with Virgin America. "American carriers are all very much the same, and the people who run them do not think of the customers at all," says Branson, sitting in the first row of one of the airline's parked, white-and-red painted A320s. "It's become a bus service." As guests mingle on the tarmac under the bright Texas sky, the interior lights bathe the cabin in a deep magenta, meant to evoke dawn. "If everything is a joy, if you come onto a plane and the lighting is right, the seating is right, and the cabin crew is happy, you feel welcome," Branson says. "It's like you have come into somebody's home."

Over the last two decades, Branson has applied a focus on customer service and industrial design to an array of businesses, some more successful than others. His Virgin Group has started companies, or licensed its brand to startups, in such varied fields as mobile phones, trains, hotels, soda, vodka,



Flight attendants at the Dallas route rollout



Branson displays his support for Willie Nelson at the Winspear Opera House in Dallas



Virgin America CEO David Cush at Dallas Fort Worth Airport

magazines, condoms, and, most recently, space tourism.

Branson first tried to start a domestic U.S. airline in the 1990s and discussed teaming up with former Southwest Airlines executive David Neeleman. Branson was concerned, however, about a U.S. law restricting foreign ownership of domestic airlines, which would require him to turn over control of the Virgin brand to Neeleman. The Federal Aviation Act of 1938, meant to allow airlines to be commandeered by the military during wartime, limits foreigners to owning 49 percent of a domestic airline.

Neeleman went on to start JetBlue, which won its flying certification from the Transportation Dept. in just three months, and went public in 2002. Sitting in the airplane at DFW eight years later, Branson says, "The team at Virgin was probably slightly too greedy. We were slightly nervous about not controlling the Virgin brand and wanted to get the foreign ownership law changed so we could own the airline." Branson says he lost faith in the possibility the law would be changed and by 2004 had decided to take a different approach.

To finance the new effort, Branson hired the investment bank Lazard to canvas U.S. private equity firms, which he says expressed little more than morbid curiosity about the idea of starting an airline in the difficult travel environment after Sept. 11. Two firms with no prior history in the aviation industry finally pledged backing: Cyrus Capital Partners, based in New York, and Black Canyon Capital in Los Angeles. Both minimized their risk by structuring their investments with put options, which guaranteed them the right to sell their shares back to the airline with an 8 percent gain if the startup did not meet certain benchmarks. Branson believed the structure was enough to satisfy the foreign ownership restrictions. He also poached charismatic Delta Air Lines President Fred Reid, who started his career as a reservations agent for Pan Am and was later an executive at Germany's Lufthansa. Reid set up the first office of the fledgling airline in New York City, in a three-room office with no running water and sporadic heat.

With startup capital in hand, Virgin America ordered 16 Airbus jets and set about making them Virgin planes. There would be plush leather seats, translucent barriers between flight classes to make the cabin seem less claustrophobic, and a touchscreen entertainment system that offered dozens of on-demand movies—many more than competitors—and the ability to have snacks and meals ordered from your seat at any time.

In the spring of 2006, with Virgin America applying for certification from the Transportation Dept., Continental and American Airlines led a battle to block Branson from U.S. skies. In petitions to the DOT, the legacy airlines questioned Virgin America's compliance with the foreign ownership law, arguing that investments with put options did not amount to true equity ownership and that the billionaire Brit was secretly pulling the strings.

The ensuing regulatory fight, waged with lobbyists in Washington, Sacramento, and Virgin's new home base in San Francisco, lasted 18 months and included a provisional rejection of Virgin America's flying certificate in December 2006. Through it all, most of Virgin America's 16 planes sat unused and empty, though a few were subleased to other airlines. Branson calls the delay a "horrendous waste of money" and says competitors "went to extraordinary lengths to smother us at birth." He declines to specify how much capital was wasted, but one person with knowledge of the company's finances during those years, who spoke anonymously because the number was never formally disclosed, says Virgin America burned through more than $100 million of cash waiting to take off.

To win its flying certificate, the Virgin Group had to make accommodations, including forfeiting the right to veto decisions about plane purchases. Fred Reid was also forced to resign as CEO; the legacy carriers accused Branson's handpicked chief executive of being too close to foreign interests.

With David Cush newly installed as CEO, Virgin America's inaugural flight, from JFK to San Francisco, finally took off in August 2007. Adding to all the standard difficulties was an historic spike in oil prices, which peaked at $145 a barrel in July 2008. While rivals had purchased futures to minimize the impact of higher fuel prices, "the delay and uncertainty in our startup limited our ability to hedge oil," says Donald J. Carty, Virgin

America's chairman and a former CEO of AMR, parent of American Airlines. For the first nine months of 2008, Virgin America announced a $175.4 million loss on $259 million in revenue.

After such a tortured launch, both U.S. investors exercised the option to sell their stakes back to the airline. The company faced a simultaneous cash and regulatory crisis, since Branson's stake now exceeded 50 percent. In the ensuing refinancing, the Virgin Group lent Virgin America another $60 million (which did not increase its stake), and Cyrus Capital agreed to step back in with a $20 million loan and assume the majority ownership position. Virgin America board members like Cush, Carty, and Samuel K. Skinner, a former Secretary of Transportation under George H. W. Bush, also took a collective 21 percent share of the company to keep it in regulatory compliance. But the damage had been done: By the time the company got the DOT to confirm the legality of its new ownership structure, Virgin America was far behind on its own plans for expansion. It initially predicted it would fly to 10 cities in its first year of service and 30 cities within five years. The airline didn't hit city No. 10—Fort Lauderdale—until two years after it started flying. Dallas is just its 13th destination.

Mo Garfinkle and other analysts worry that the young airline has not grown fast enough to sustain a profit and has only $25 million in the bank. David Cush says the airline also has a $75 million line of credit, though he concedes that "any airline exec will tell you more cash is a good thing." Don Carty, the chairman, says an initial public offering "is at least 18 months away."

It will likely need the cash. New airlines need to grow quickly to entice travelers with an array of destinations and a choice of departure times, and to help with rescheduling nightmares like the one caused by last week's blizzard on the East Coast—some passengers on canceled Virgin flights were being asked to wait a week for a new flight.

Virgin America has aggressive plans for expansion, with orders for 56 new jets over the next six years. It wants to introduce service next year to airports like George Bush Intercontinental in Houston, where Continental is based, Hartsfield Jackson Atlanta, home of Delta, and Chicago's O'Hare, which United counts as a major hub. Virgin hopes its distinctive service is enough to lure travelers away from those airlines.

The strategy is an unconventional one. "In this business you have to own something," says JetBlue founder Neeleman, who now runs a Brazilian startup airline, Azul, and is skeptical of Virgin America's chances. "Skimming off popular routes leaves you too vulnerable. People can come in and match your fares with better frequency."

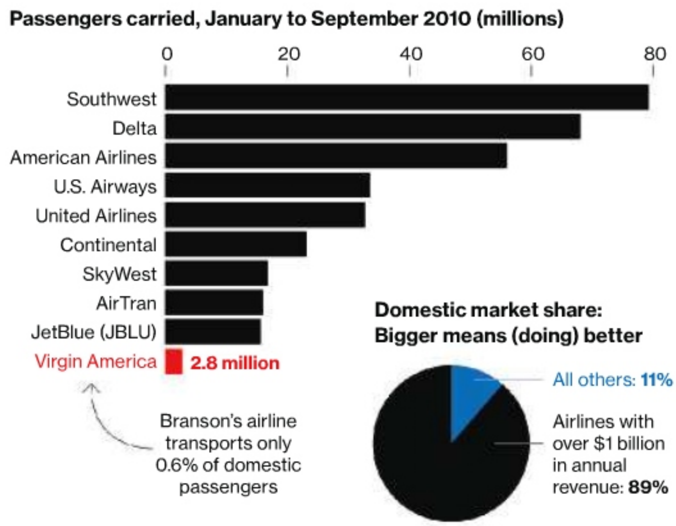
American's reaction to Virgin's incursion into Dallas provides a glimpse of what the airline can expect as it enters the territory of deeper-pocketed rivals. Since Virgin started selling tickets to Dallas over the summer, American added two flights a day to Los Angeles and San Francisco and cut its fares on those routes by about 25 percent.

Furthermore, any airline can add the sorts of services and amenities Virgin features. Carriers including Delta and United are currently adding Wi-Fi throughout their fleets. Continental is in the process of bringing satellite television to its planes, though passengers have to pay for it, and Boeing has integrated color LED mood-lighting into the designs of its new 737. Virgin America's in-flight system is already showing signs of age. Passengers hardly need an in-flight chat room, or a store that offers Callaway golf bags for $400, when they are surfing the Web and e-mailing friends on their laptops.

"We don't worry about the last product we put out," says Cush. "We are thinking about the next one." That next one would be what the company calls Cabin 2.0, a new design that will include more responsive touchscreens, more channels of live television, and multiplayer video games. Nor does Virgin plan to lose the mood lighting war: It is examining LED lighting systems that can display thousands of colors instead of the current twelve shades of pink, purple, and blue. "We are not going to sit back and let the other guys overtake us," says Cush.

What Virgin America may really need is more Branson. In a perfect world, he could freely inject capital, or even merge the airline with Virgin Atlantic, shaving off costs and allowing it to offer service more quickly to more cities. The foreign ownership laws, however, make it hard for him to work his usual magic in all but the most superficial ways. A few hours after the party on the tarmac at Dallas Forth Worth airport, Virgin America hosted more than 1,000 guests at Dallas' Winspear Opera House for a concert by Willie Nelson, days after his latest arrest for marijuana possession. Introducing the country crooner, Branson joked that Nelson and Virgin America have much in common: "We both like to fly high," he cracked. The crowd laughed, then celebrated throughout the night. After the event, even close backers acknowledged the flight ahead could be rough. "It's sad. There's a confluence of things working against these guys," said Fred Reid, Virgin America's first CEO, adding, "I'm hopeful because this is the right thing for air travelers." ❸

Little room for small airlines
The big legacy carriers dominate the skies



DATA: BUREAU OF TRANSPORTATION STATISTICS

Competitors "went to extraordinary lengths to smother us at birth," says Branson

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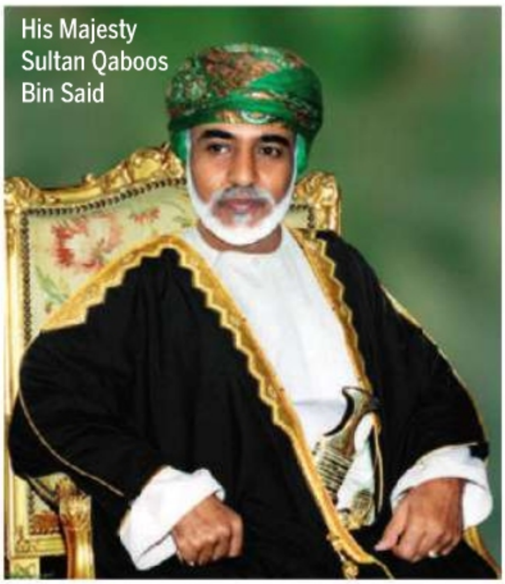
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The sultanate of Oman: celebrating four decades of progress



His Majesty Sultan Qaboos Bin Said

A SULTAN'S 40 YEAR WAGER HAS PAID OFF

When His Majesty Sultan Qaboos, assumed power over Oman in 1970, he had an ominous task laying before him. Oman - historically a strategic hub on the global sea routes, stretching all the way to Zanzibar - had fallen vastly behind its neighbors in its attempts at modernization. The country suffered from an unstable economy, low standards of living, political and social instability, and an utter lack of infrastructure.

Today, Oman is in many ways unrecognizable to its former self, thanks largely to the Sultan's meticulous planning and tireless commitment to reform. Over the course of 7 ambitious five-year plans, the Sultanate has found success in transformation, unlocking the potential in the nation's resources and in its people.

The United Nations' 2010 Human Development Report ranked Oman the world's 'top mover' in its Human Development Index (HDI)

The figures speak for themselves. Since 1970, Oman's GDP has increased a dizzying 170-fold. GDP per capita, on par with the MENA region (PPP) as recently as 1980, now has surged to nearly three times the region's average. The nation today ranks as one of the world's top ten in primary health care provision.

Not surprisingly, the United Nations' 2010 Human Development Report ranked Oman the world's 'top mover' in its Human Development Index (HDI), confirming the country's impressive improvements in 'health, education, and basic living standards' over the past 40 years.

The Sultan's key to success, it seems, has been reinvesting oil profits back into the Omani economy and its people. According to H.E. Ahmed Macki, the Minister of National Economy, in 2010 Oman invested a whopping 17.8% of its budget on social structure funding, including education and vocational training programs. With conservative oil forecasts built into its budget, resurgent oil prices will bring even further cash to programs. In the first half of 2010, the government has already shown a 31% jump in revenues.



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Yet, despite the rapid speed at which the country has progressed, Oman has not abandoned its history, traditions, and uniquely Omani characteristics that set it largely apart from its Middle-Eastern neighbors.

Addressing his national council on the significance of Oman's achievements, H.M. Sultan Qaboos stressed, "Everything that has been achieved with a precise balance between preserving the best elements of our heritage, in which we take pride, and the demands of the present day which require us to adapt to the spirit of the modern age."

Now, as the Sultanate concludes its 7th five-year plan (2006-2010), and prepares to embark on its 8th, this careful blend of traditional and modern looks sure to propel the country to new heights. Oman has indeed emerged on the world stage and its economy, forecasted to grow at 6.1% this year, offers equally promising returns to savvy investors looking for long-term growth potential.

Economic **Expansion and Diversification**

Like many of its neighbors, the Sultanate's economy has been driven by the creation and expansion of a vibrant oil industry. First discovered in 1964, the Omani government today produces roughly 875,000 bpd, recording output in September 7% higher than 2009 levels according to Ministry of Oil and Gas Under Secretary H.E. Nasser al-Jashmi. The Ministry recently confirmed to Bloomberg that it has plans to expand production to reach the important one million bpd threshold by 2015.

At the helm of this growth is state-owned **Oman Oil Company (OOC)**. Established in 1996 by the government to better manage oil investments and utilize the country's oil reserves, OOC has increasingly made its mark overseas, with strategic investments in 9 countries.

Perhaps most importantly for the country, OOC has aggressively moved its investment downstream into infrastructure, shipping, petrochemicals, refining and metals. Having known the fiscal hardships of oil crises, the Sultan has long been wary of resource overdependence and has placed the nation on a steady path towards economic diversification.

A bevy of high tech industrial parks scattered throughout the Sultanate – including Sohar, the nation's industrial engine - has facilitated this transition. Groundwork for future Industrial Parks and a Free Trade Zone has already begun.

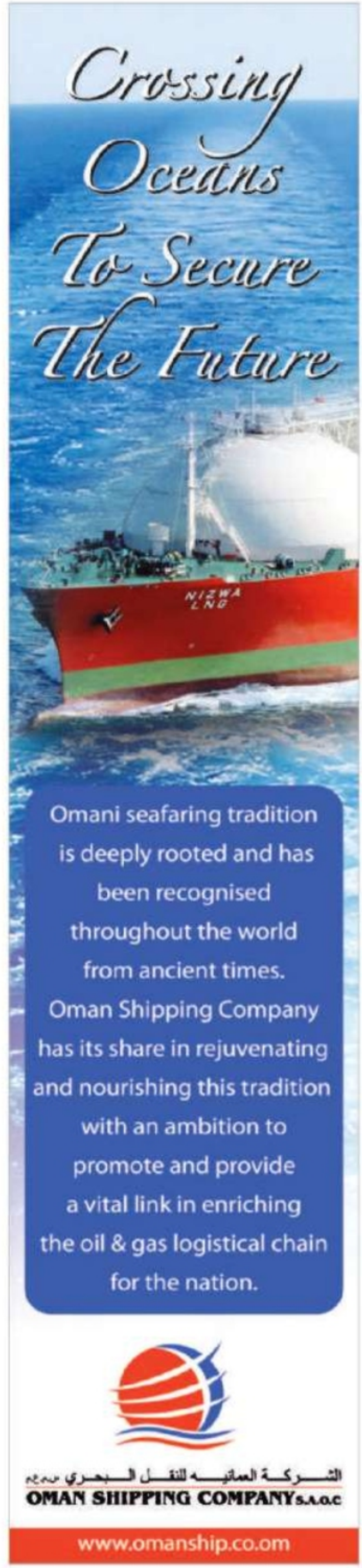
A shining example of the country's value added economic trajectory is **Sohar Aluminium (SA)**, a state-of-the-art aluminum plant launched in 2008 by OOC and multinational partners. SA plans to sell '60% of its annual production capacity' to companies based onsite in Sohar, evidence of a strong clustering effect already taking place within the Omani economy. In its short life, Sohar Aluminium has proven a big success. Company stakeholders have already begun talks to undergo a large-scale upgrade to its smelter, roughly doubling its capacity to 720,000 metric tons per year.

"We want Sohar Aluminium to grow," explains SA CEO Henk Pauw. "It is very strategic for Oman and Sohar Aluminium plays an important part in Oman's plans for its future. Not so much the smelter on its own but also the downstream here at the port of Sohar and Sohar Free Trade Zone."

Nearby in Sohar, construction is just finishing on an industrial complex to house the **Vale Oman Pelletizing Company**, a 30/70 joint venture between OOC and international mining giant Vale, which was inked in May. Vale, which moved its Middle East headquarters to Muscat in 2007, will use its Sohar facility for processing raw iron ore from Brazil and exporting to regional markets.

"[For] almost 5 years, we were looking for an alternative in the region to settle our operations in this very important part of the world," recalls Sergio Leite, Chief of Vale's Oman operation. "Then we were invited to visit Sohar industrial port and we realized its importance from a logistic point of view, as it is a deep water port outside the gulf region."

Perhaps one of the most successful chapters in Oman's economic diversification story has been that of the **Oman Indian Fertilizer Company (OMIFCO)**. Formed as a joint venture between OOC and Indian partners, OMIFCO took advantage of the high demand for fertilizer (Urea) in India and the availability of gas in Oman to sign a supply deal with the government of India at a low price - supplying excess capacity at now soaring market values. The venture has paid of tremendously.



worldmags

Focus on **Competitiveness**

OMIFCO's success and the success of the countless others multinationals active in Oman today tell the story of the country's rapidly growing competitiveness. In the 2010-2011 WEF Global Competitiveness Report, Oman improved 7 rankings from 2009-2010 to become the 34th most competitive country in the world.

One way the Sultanate achieved this was by cutting all unnecessary barriers and stifling bureaucracy – forging a world-class center for business. "We have put in place a One Stop Shop," Minister of Commerce and Industry H.E. Maqbool Sultan explains. "Now you can form a company in hours electronically."

> "One of the main advantages is that Oman has been very stable since 1970, it has given us an opportunity to plan, to look forward."

Others point to the steady course of progress, laid out by a comprehensive 40 year development plan, as key to the nation's economic success.

"One of the main advantages is that Oman has been very stable since 1970," explains Mr. Khalid Al Zubair, Managing Director of The Zubair Corporation. "It has given us an opportunity to plan, to look forward."

The Zubair Corporation has seized upon this opportunity, building a diverse empire of over 60 wholly owned companies, subsidiaries and associates in Oman and around the world. Founded in 1967 as a "simple paint shop," the same year that oil began flowing from Omani wells, **The Zubair Corporation's** areas of expertise have gradually diversified into a wide range of competencies, from automotive to tourism. This in many ways reflects the country's own maturity and shift away from oil dependence.

Together, the country and the corporation have shared many first, remembers Al Zubair. "The first power generating station was built by us. The first transportation was founded by us. The first fixed phone network was installed by us and [we] had very early alliances with foreign companies. We had the vision of finding out where the country was going, where the opportunities would be in the following years."



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Investing in the People

One of Zubair's primary goals, through the corporation's many multinational partnerships, is to train Omani workers to fill all job openings - a process known as "Omanisation." As one of the pillars of the Sultan's growth strategy, the Omanisation process has through the years elevated the skill level of the local workforce and provided a layer of labor market and macroeconomic stability rare in the region.

"It is easy to get everything from outside, investments, executives, labor," explains Minister of Commerce and Industry H.E. Maqbool Sultan. "But human resources development was and is one of our priorities."

Thus, trading off the short-term labor market rigidities inherent in the program, the country's long-term competitiveness is undeniable- fuelled by a highly skilled, dynamic young workforce.

"Having young employees is both a challenge as well as an opportunity," says one representative of **Oman Shipping Company (OSC)**, one of the fastest growing Omani ventures. "Young minds can absorb technology very fast; they have a lot of ambitions and are ready to work hard."

A skilled young Omani workforce will certainly be critical in continuing the course that OSC, a joint venture between the Omani government and the **Oman Oil Company**, has charted. Founded in 2003 as a predominantly LNG oriented operation, the young shipping company has already capitalized on the surge in dry bulk and liquid markets – catering to the industrial operations sprouting up throughout the nation's industrial zones. The venture has exceeded expectations: OSC currently owns 19 vessels, but is now realizing an ambitious plan to increase this number to 42 by the end of 2012.

Some might say that OSC's success is enhanced by and indicative of the country's longstanding geo-strategic location. Indeed, for centuries Oman has occupied one of the world's most valuable hubs for global commerce. However, until recently, Oman had failed to capitalize in modern times on its positioning due to an often times non-existent infrastructure. This trend, thanks to the Sultan's long-term strategic plan, has long been reversed.



We are a global mining company. We are present around the world, including in Oman.
In 2009 we began building a new industrial complex in Sohar, which includes a pelletizing plant and distribution center.
The goal is to generate 720 direct and another 1,800 indirect jobs during the start-up phase. In all, around US$2 billion will be invested in the project. This is the mining of the future, helping to improve the future of Oman. Today and tomorrow.
Vale. There is no future without mining. And there can be no mining without caring about the future.
VALE

worldmags

Reopening an Ancient Gateway to the Middle East and Beyond

When H.M. Sultan Qaboos came to power, the Sultanate of Oman had no more than 6 miles of paved roads to its name. Today, an extensive grid of modern highways, ports, and airports connect every corner of the vast country and link it to the busting commercial network of the surrounding region.

"There has been a quantum leap during the past four decades since H.M. Sultan Qaboos Bin Said took over," explains H.E. Dr. Khamis Al Alawi, Minister of Transport and Communications, highlighting the profound economic effect such changes have brought to the country.

"To change regulations and encourage foreign investment is not enough," says H.E. Maqbool Sultan on the Sultan's vision for economic growth. "You need to have the right infrastructure for business, like having Free Zones, ports, airports and roads."

One of the largest infrastructure investments has been the development of major airports throughout the country.

The government is betting that enhanced accessibility to some of Oman's more remote and beautiful regions will promote the burgeoning tourism sector like never before.

In preparation for an estimated boom in arrivals, Muscat International Airport too is expanding its wings- embarking on a massive and costly upgrade to facilitate 12 million passengers per year.

"We are talking of a structure of 530 thousand square meters and two runways," says **Oman Airport Management Company** CEO George Bellew. "The mandate that we have from the government is that they expect a performance by way of services delivered to users, which is truly world's best practice." Plans have already been tabled for future expansion up to 48 million passengers.

The government is betting that enhanced accessibility to some of Oman's more remote and beautiful regions will promote the burgeoning tourism sector like never before

Finally, the country is rapidly building upon its already impressive ports network to become a dominant player in global logistics. The Port of Duqm, for example, now under construction, will be one of the largest dry docks in the region upon completion.

"The Sultanate's government realized that the exploitation of [its location] would create a major economic contribution to the national income through the development of harbors and ports," explains Undersecretary for Ports and Maritime Affairs H.E. Said Al-Harty.

The nation's value as a strategic trading hub has not gone unnoticed, with many countries seeking to leverage easy access to the Middle East, Africa, and Asia while bypassing the Straits of Hormaz. Oman now enjoys a Free Trade Agreement with US, testament to the long-term strategic advantage of Oman's potential as a global gateway.

The government is now targeting more partners and investors from around the world to help build upon the miraculous success of the past 40 years.

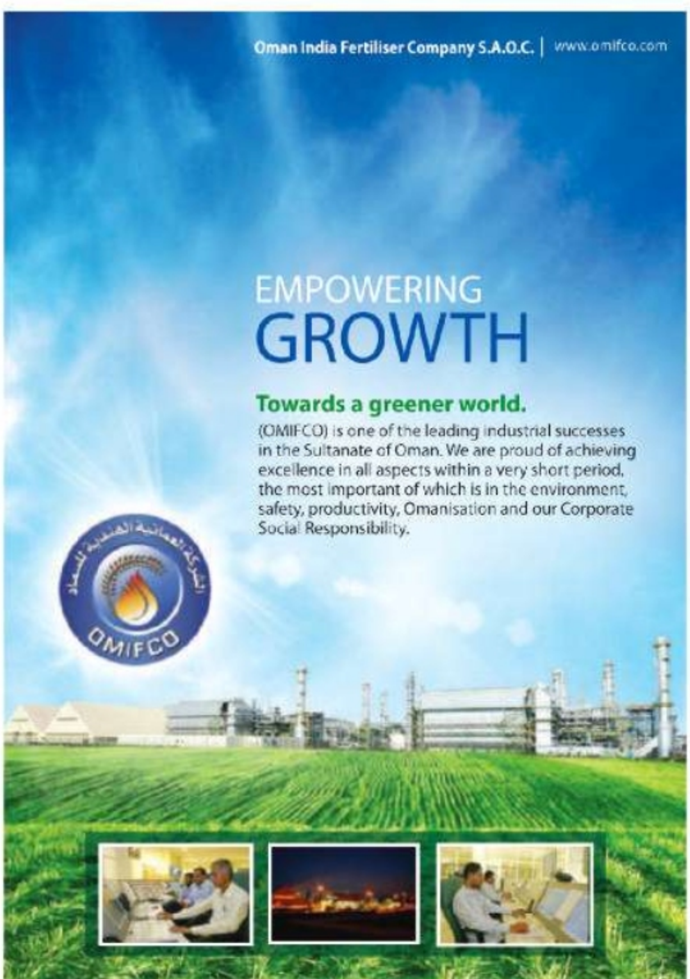
"Oman is an ideal platform for growth; the stability of our market, of our political system, of our laws and regulations," says Khalid Al Zubair. "From a partnership in Oman, your reach will be regional and global."

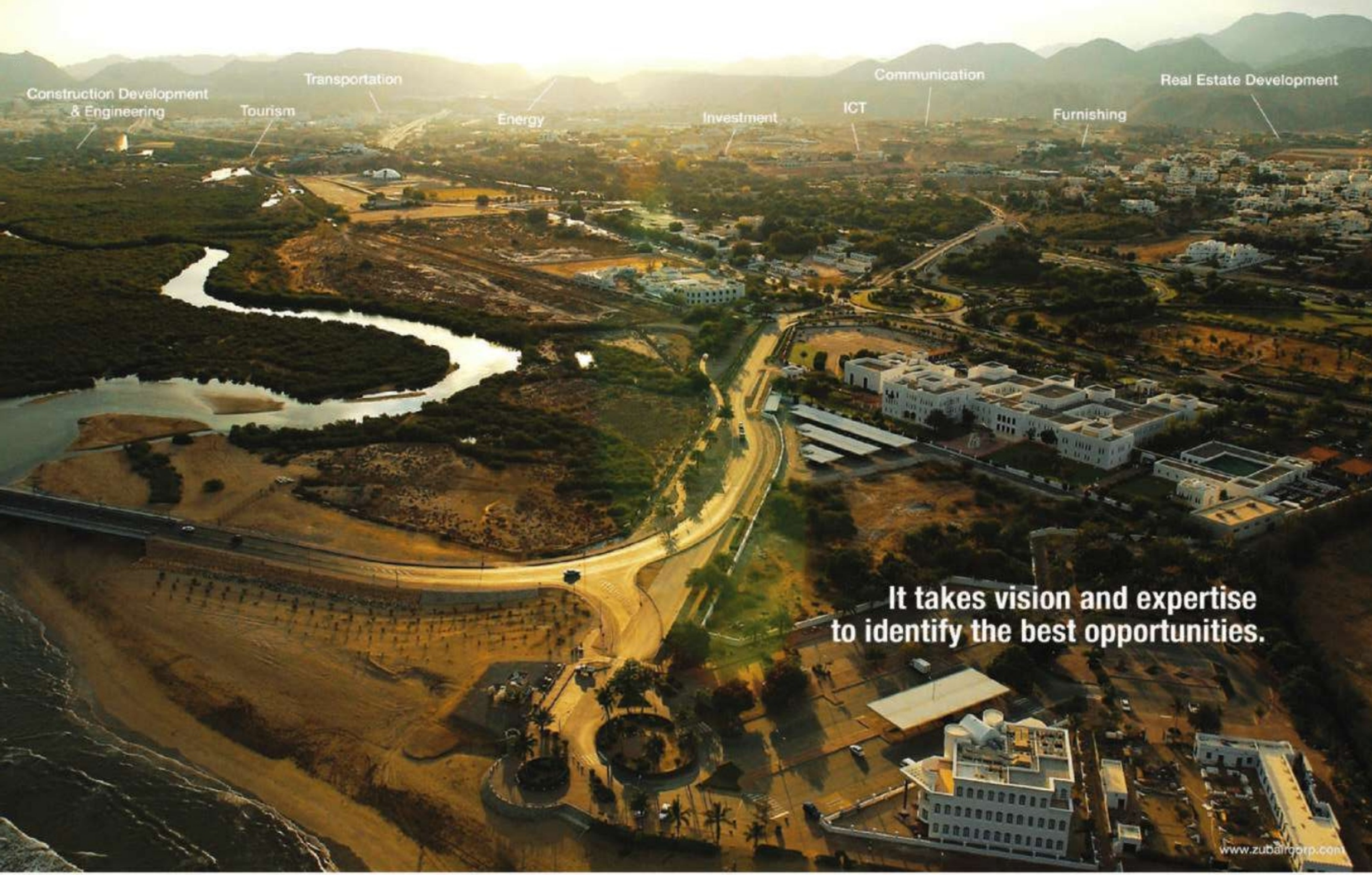
Such optimistic statements, pouring in from Oman and around the world, confirm much of what too can be seen on the ground: a proud young nation that has transformed itself in the blink of an eye into a economic powerhouse, eager to play a greater role on the world stage.

"Here we are today, in this splendid land, celebrating the 40th anniversary of its progress," said the Sultan recently, reflecting on the nation's progress. "[The Country's] achievements in many fields are plain for all to see and have changed the face of life in Oman, enabling it to assume a position of eminence at both regional and international levels."

One can only wonder what the Sultan has in store for the next 40 years.

The Bottom Line: *Relying on long-term vision, economic diversification, and domestic reinvestment, Oman has avoided the pitfalls of financial and real estate bubbles that have plagued the region. Bet on robust, sustainable growth from the Sultanate for years to come.*





Opportunities are all around, and we have the know-how to make them happen. For over four decades, The Zubair Corporation has played an integral role in the development of the Sultanate of Oman and the region, in almost every major industry, and we are continually looking to explore new partnerships, establish business relationships to build our vision for the future.

To learn more about how we can work together, contact us at bd@zubaircorp.com

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مؤسسة الزبير
The Zubair Corporation
Future Ready

Advantage: RIMS

Advantage: Opportunity

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Salutations for the app class of 2010
Page 80

The Best Apps & Cheap Wine & Rap Moguls

Etc.

She may not be Tolstoy, but Lauren Conrad is a rapidly growing brand
Page 84





ETHAN MILLER/GETTY IMAGES

Welcome to the Soy Luck Club

Tao Las Vegas is America's top-grossing restaurant. The secret? Lacquer, celebrities–and slots-playing grannies. *By Joel Stein*

worldmags

Etc. Tao Las Vegas

In 2009, Tao Las Vegas brought in more than $59 million from its restaurant, lounge, and cabanas

Stretching 62,000 square feet in the lobby of the Venetian Resort Hotel Casino, Tao Las Vegas looks like the temple Siddhartha would have built if he'd been a gangsta rapper. The restaurant, which opened in 2005, has high ceilings, a 20-foot-tall Buddha, a pool filled with Japanese carp, lacquered everything, and Quentin Tarantino lighting. It's a restaurant that hires people whose sole job it is to put on a bikini and sit in a bathtub filled with roses—and pays Kim Kardashian to throw its New Year's Eve party.

So it shouldn't be surprising that Tao Las Vegas is also the highest-grossing restaurant in the U.S., by far, according to *Restaurants & Institutions* magazine. In 2009, the restaurant brought in $59,292,345, more than double what the runners-up each made (New York's now-defunct Tavern on the Green, $27 million; Miami's Joe's Stone Crab, $26 million; New York's Smith & Wollensky, $25 million). All this despite the worst recession in the history of Las Vegas. The economics of the restaurant business are so wretched that while Tao Las Vegas has made it to the top of the magazine's list of the highest-grossing independent restaurants for the past five years, *Restaurants & Institutions* folded in April.

Tao pulls them in with Vegas-size ambition and subtlety. It also tries to prevent guests from ever leaving. Diners are encouraged to drink in the lounge, eat in the restaurant, and pay $20 or more to get into the nightclub—where they can spend $400 for a bottle of vodka. The next morning, they can drink off their hangover in a $2,000 rented cabana at Tao Beach, next to the hotel pool, where the menu includes massages. Tao Las Vegas' projected 2010 sales include $28 million from the restaurant and lounge, another $28 million from the club, and $10 million from the pool. The company is considering expanding into hotels, cruise ships, and even its own island.

As Tavern on the Green's 2009 bankruptcy has demonstrated, pulling in lots of money doesn't guarantee profitability. Yet because of Tao Las Vegas' size and alcohol sales, Ron Paul, the president of food industry consulting firm Technomic, believes it is the most profitable restaurant in America. Tao Las Vegas, Paul says, is "as big as some Whole Foods stores. Nobody is doing anything near that volume."

While most restaurants aim to make about 30 percent of their revenue from alcohol, Tao Las Vegas takes in about 75 percent. "When we buy vodka, we buy it by the pallet," says Rich Wolf, one of four partners in Tao Group, which owns 12 restaurants and seven clubs in Vegas and New York. "We have a different model. We're throwing a party with a restaurant," he says. Thirteen-dollar Tao-tinis and Tao-hitos might be profitable, but it's hard to sell alcohol over the long haul. "You get a bottle for $10 and sell it for $400," says partner Paul Goldstein. "But how do I get 400 people in a nightclub every single night?"

The answer, it turns out, is more complicated than merely hiring scantily clad women to bathe in a tub with roses—or calling Kim Kardashian's agent. When Tao Las Vegas opened at the Venetian, a hotel built largely to accommodate the huge convention center attached to it, many predicted failure. Remembers Wolf: "They said, 'There's no vibe at the Venetian. It's all conventioneers. It's dead after 10 p.m.' " So the restaurant adjusted by marketing to the conventioneers during the week before letting in the club kids. As a result, both contingents can say they partied at Tao Las Vegas without knowing the other did. The models don't have to see the Midwestern salespeople, and the

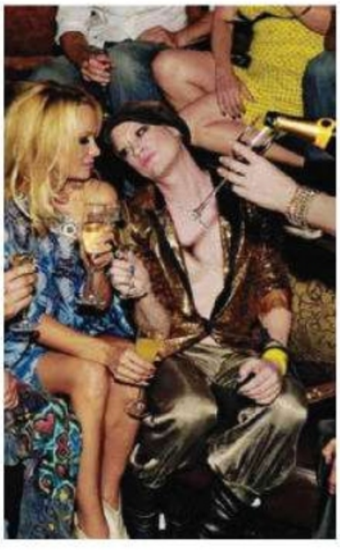
Rumer Willis, the offspring of Demi and Bruce, celebrates her 21st birthday at Tao Las Vegas in 2009



Singer Christina Aguilera rings in 2010 at the venue's nightclub



Baywatch alumnus Pamela Anderson and designer Richie Rich



Midwestern salespeople don't have to fret about being rejected by models.

Tao Las Vegas also markets to the pre-theater crowd for early evenings and to families on Sunday nights. "The ladies that play nickel slots also have to eat," says Goldstein. "They come into Tao at 5:45 and they're out by 7:30. Then we get our normal crowd in. If you're making $20,000 before 8 o'clock, that's a good thing." It's a particularly good thing in a town where new restaurants are constantly vying for the attention of celebrities. "At some point you have to come down to earth and say, 'Hey, we're selling Chinese food!' " says Kim Kurlanchik, another partner. "The A-list only comes for so long. So you better be nice to the grandmas and the babies."

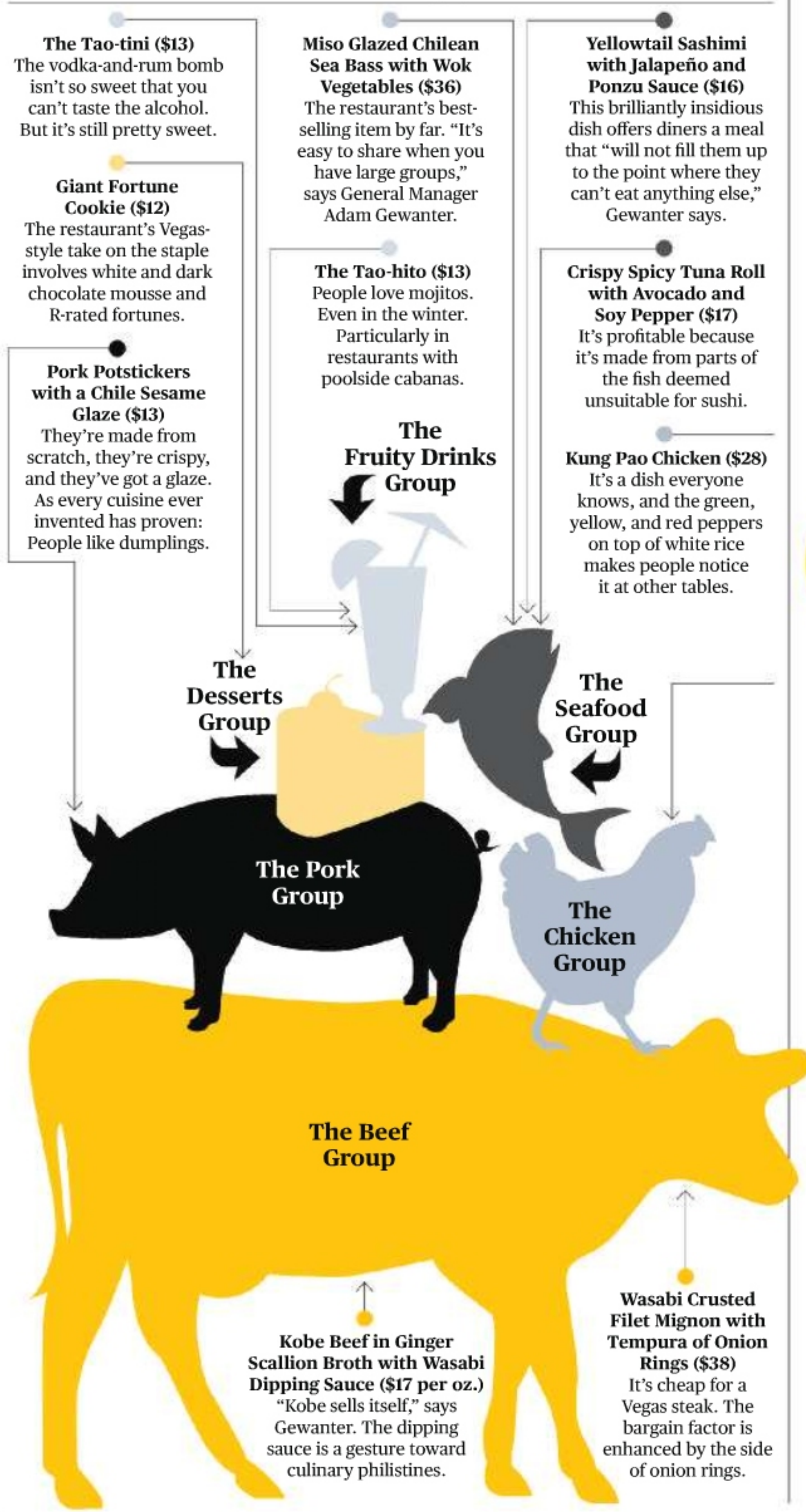
The menu, which pairs generous portions of Chinese food and sushi in a way that isn't particularly Chinese or Japanese, caters to a demographic that can best be described as American. "Asian style makes it very fast. As it's ready, it comes up," says Corporate Executive Chef Ralph Scamardella. "People don't have to wait for their entrées. Especially with the wok stuff. It comes out in five or six minutes. That's by design." Tao Las Vegas serves about 1,400 dinners on a weekend night, with an average check of about $70 per person. Because dinner prep starts at 7 a.m., chefs can make a lot of dishes that just need to be finished off for a minute in the oven before they hit the table.

Even the kitchen is ridiculously large. On Saturdays, the restaurant employs 57 cooks, 8 chefs, 26 servers, and 10 hostesses to make sure things move quickly. At dinner, the executive chef stands behind a microphone to direct the cooks. The dishes, such as the three most popular–Miso Glazed Chilean Sea Bass with Wok Vegetables ($36), Kung Pao Chicken ($28), and Wasabi Crusted Filet Mignon with Tempura of Onion Rings ($38)–are all big and uncomplicated. While the menu does have dishes that lose the restaurant money, such as the $88 Kobe Ribeye, Tao Las Vegas' food costs are, at 25-30 percent of its budget, a little lower than the industry average. Largely because of its giant, chocolate mousse-filled fortune cookie, 30 percent of diners order dessert. That's remarkable for any restaurant, especially one where many patrons are half-naked and about to dance.

One problem the restaurant hasn't yet resolved is that after spending an hour and a half making a guy and his bachelor party feel special, a bouncer in front of the velvet rope might tell them they can't get into the club. "It's probably our biggest single challenge," says Wolf. "We can deliver a great experience at the restaurant, but if they don't get into the club, they don't have a great experience. We bend over backwards, but a group of 20 guys at a bachelor party? That's a tough one." The genius of the business plan, however, is that the restaurant gets them so drunk that they don't remember being turned away. Ⓑ

The Tao Las Vegas Food Pyramid

The secrets behind the restaurant's most popular dishes



OPPOSITE PAGE: DENISE TRUSCELLO/WIREIMAGE (3)

The Apps Class of 2010

Saluting all the year's best, weirdest, and coolest mobile apps

Most Popular



Angry Birds
This oddly addictive game—in which players launch birds at pigs—is the No. 1 paid iPhone app. *99¢*

Most Likely to Bulk Up



Mario Batali Cooks!
The Croc-wearing chef's foray into apps is a blueprint for how cookbooks may evolve. *$2.99*

Biggest Ego



Twitter
Twitter released its first official iPhone app in 2010, instantly rendering all other Twitter apps obsolete. *Free*

Most Extroverted



Momento
This virtual diary aggregates your posts to Facebook, Foursquare, Twitter, Flickr, and other sites. *$2.99*

Most Likely to Succeed



Pulse News Reader
News junkies can compile their favorite RSS feeds in an image-rich layout. Steve Jobs is a fan. *Free*

Most Photogenic



Instagram
Apply moody filters to your mobile snapshots. Even real photographers dig this service. *Free*

Biggest Tech Geek



Dropbox
A personal cubbyhole in the cloud, Dropbox makes it easy to store and sync across computers. *Free*

Most Ambitious



CardMunch
Take a picture of a business card, and it will be converted into a digital contact. *Free download, $25 per 100*

Most Seductive



Word Lens
Instantly translate foreign languages while scanning menus, signs, or documents. *$4.99/language*

BOOK: HALFDARK/GETTY IMAGES

Biggest Loudmouth

Dragon Dictation
Dictate e-mails, texts, and notes by talking into your phone. It's much faster than typing. *Free*

Most Glamorous

Netflix
Netflix waited until 2010 to introduce an app. It was worth it. *Free with $7.99/month subscription*

Most Colorful

DanKam
Helps color-blind people—such as approximately 10 million American men—to distinguish hues. *$2.99*

Biggest Teacher's Pet

Due
An easy way to jot down a quick reminder or set a timer. The pop-ups are annoying but useful. *$2.99*

Class Bully

Fruit Ninja
Spend hours swiping a digital kitana blade through lobbed watermelons, oranges, and pineapples. *99¢*

Class Clown

Younicorn
Add a unicorn horn to anyone in your photo library. Yes, it's ridiculous. But it's also pretty funny. *99¢*

Most Likely to Live in Brooklyn

Mixologist
Shaken or stirred? Who cares. This home bartender app is a cocktail recipe library in your pocket. *99¢*

Most Likely to Blow Rent on iTunes

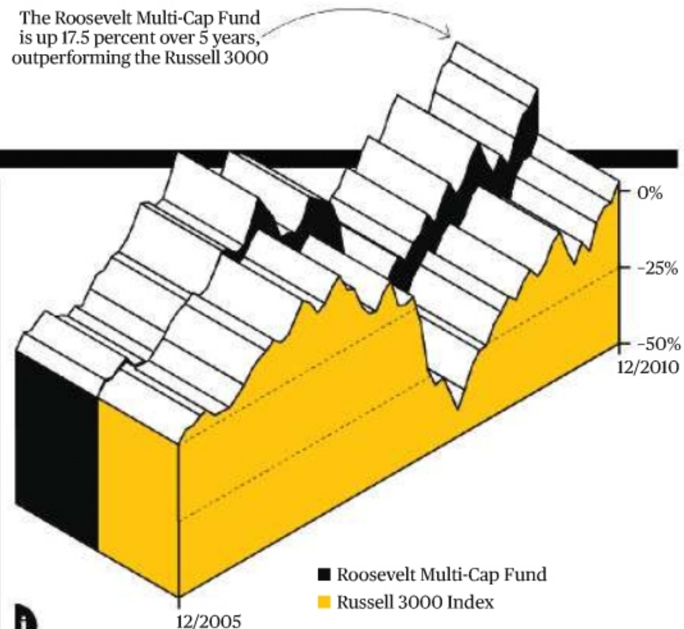
SoundHound
Can't name that tune? Play (or hum) it near your phone and SoundHound identifies it. *$4.99*

Biggest Sci-Fi Nerd

Plants vs. Zombies
An addictive game in which your garden fights back against the approaching zombie hordes. *$2.99*

—Barrett Sheridan

Change We Can Invest In



At Roosevelt Multi-Cap Fund, Jason Sheer buys companies that are transforming their business models

We are agnostic when it comes to investment style. We buy both growth and value stocks of any size. Our key advantage is the ability to identify positive changes at companies while managing the downside risk. We often look for companies that are transforming themselves from one business to another and are therefore being misperceived by the market. These stocks may be trading at valuations that are inappropriately low: They are falsely identified as belonging to a certain industry group and trading at prices representative of that sector. If we are correct that the company is being misunderstood, there is the potential for significant stock appreciation. If we are incorrect, we have exposed ourselves to limited downside risk, since we are paying an appropriate valuation for the stock. B
—As told to Lewis Braham

THE STATS DATA: BLOOMBERG

New York-based Roosevelt Investment Group manages $5.5 billion in assets. Its Multi-Cap mutual fund has a five-year annualized return of 5.3 percent, vs. 2.8 percent for the Russell 3000 Index.

Sheer on his picks ...



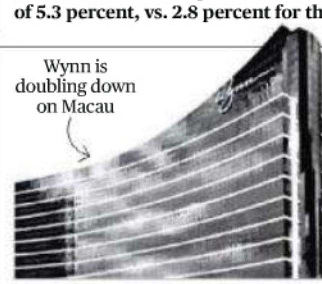
1. Hasbro

Hasbro has a joint venture with Discovery Communications to start a kids' TV channel that would feature many of its toys. This could add significant value to the company. After the news of the partnership came out, we believed the market was still viewing Hasbro as a toy company instead of a broadly diversified media company. And for the last five years the sales of media-backed toys have expanded 30 percent, vs. a 14 percent drop in non-entertainment-backed toys.



2. Compass Minerals

Compass Minerals is largely perceived as a salt supplier for the highway deicing market, even though 25 percent of its cash flow comes from creating a specialty fertilizer. Sulphate of potash (SOP) is a fertilizer used principally for crops such as fruits and vegetables. As the demand for crops outstrips supply, farmers demand more SOP to maximize their harvest, and Compass has benefited. It's trading at about 15 times forward earnings; its peers are trading at 25 times.



3. Wynn Resorts

Our investment in casino company Wynn Resorts is largely a play on Macau, since most of the company's value is from its Macau operations. That market is growing rapidly–over 50 percent year-to-date. The company is also developing a casino in nearby Cotai, which could more than double its profitability. Less than 1 percent of China's mainlanders visit Macau each year, vs. 10 percent of Americans who visit Las Vegas. This business has room to continue growing.



4. Ferro

Ferro is a specialty materials and chemicals company that produces coatings and films for a variety of markets. It's also a clean energy company. Ferro is one of two dominant players in the production of pastes and powders that go into solar cell panels. That business is becoming a larger portion of the company as it outgrows other units and carries higher margins. This will help transform what is largely a cyclical company into one with a strong growth component. It trades at 12 times forward earnings.

APPLE: LAUREN BURKE/GETTY IMAGES; WYNN: UDEN GRAHAM/REDLINK/CORBIS; DISHES: JAMES ROSS/GETTY IMAGES

Etc. One True Thing

The All-Purpose Bottle



Deceptively cheap wine that will fool your palate—and your co-workers. *By Nick Passmore*

The Want: The all-occasion wine—red or white—that's perfect for a host, a client, or an impromptu office toast. It can't look cheap or taste cheap but should cost $15 or less.

The Get: Goose Ridge Riesling 2007 ($10) and Penfolds Bin 2 Shiraz Mourvèdre 2008 ($15). Produced in Washington State, the riesling is light and balanced with notes of apples, ripe pears, and floral elements. The Shiraz turns nasty Aussie viticultural stereotypes on their head with its tart, blackberry bite on the finish. Both bottles suggest the good taste of a connoisseur. Ⓑ

MESSAGES IN A BOTTLE

Liquors that look and taste more expensive than they are



Plantation Five-Year-Old Barbados Rum

Fresh and lively, this fiery dark rum has a spice-infused finish that makes it perfect for sipping on the rocks—or mixing with orange juice and triple sec—during the winter. *$20*



Beefeater Gin Winter Edition

The added cinnamon, nutmeg, and pine shoots make this traditional blue-blood standby an ideal base for more savory winter cocktails this season. *$20*



Milagro Tequila Silver

This modestly priced tequila doesn't burn the palate like other options in its category. Plus, you can taste the agave, and it won't bring on any embarrassing spring break flashbacks. *$25*



Bulleit Bourbon

In addition to the nifty bottle—presentation does matter, after all—Bulleit separates itself from the likes of Wild Turkey and Jim Beam with its refinement and light touch. *$22*

WINE: PHOTOGRAPH BY JAMIE CHUNG FOR BLOOMBERG BUSINESSWEEK



Lauren Conrad, the millennial mogul and budding designer, at her Westwood offices

The Hills are Alive... with The Sound of Money

Reality star Lauren Conrad is tiptoeing toward Martha Stewart territory. *By Karl Taro Greenfeld*

The offices of the Paper Crown fashion line are jammed with an MTV film crew as producers walk around in headsets and speak in whispers. The second floor suite in Los Angeles' Westwood neighborhood is decorated with a zebra skin rug, an ornate table with lion's claw feet, and mannequins in half-finished gowns. Reclining on an overstuffed antique sofa is Lauren Conrad—reality TV doyenne, best-selling author, and fashion impresario—in a bright print shirt, high-waisted slacks, and high heels of her own design.

Conrad, who blasted to stardom in MTV's reality series about precocious Orange County teens, *Laguna Beach*, and its spin-off, *The Hills*, is embarking on one of the more unusual stunts in the short history of unscripted television. To cement her reputation as a businesswoman, the 24-year old is trying to distance herself from her reality TV alter ego. The chosen vehicle for this transformation? Yes, a new reality show—her third in seven years. Conrad's yet-unnamed series, which will make its debut early this year on MTV, will follow her quest to become so successful as a businesswoman that she has to eventually cancel her show. As her agent, Max Stubblefield, puts it: "Lauren's new businesses will feed on the show—which will feed on the new businesses." Conrad insists she would love "for the cameras to go away. This show is a vehicle to get there. I would love to become a big, natural brand."

Conrad's empire includes books, cosmetics, and a new fashion line

Despite being famous for little more than once having been a teenager, Conrad—known as "LC" by her legions of adoring adolescent fans—may already be the millennials' answer to Martha Stewart. She's the author of four best-selling books, including *Sugar & Spice*, which continues the chronicle of a fictional

young woman dealing with the travails of reality stardom. She's coming off a successful campaign as the exclusive spokesperson for Avon's Mark cosmetics. Since 2006 she has had endorsement deals with toy company Hasbro, leather goods maker Linea Pelle, and AT&T. Her fashion line for Kohl's, LC Lauren Conrad, has been a "consistent top performer in our women's category," says Donald A. Brennan, a senior executive vice-president for the retailer. Her slightly more upscale line, the Lauren Conrad Collection, was sold in more than 500 stores before she discontinued it last year to focus on Paper Crown. She's even done her own "Got Milk?" ad.

Unlike many reality stars of her generation, Conrad's public introduction involved neither a sex tape nor a friendship with Paris Hilton. In 2004 she was cast as the star of MTV's alpha-kid show *Laguna Beach* and wooed fans with her estimable sanity. During five seasons of the show's sequel, *The Hills*, which followed her as a student at Los Angeles' Fashion Institute of Design & Merchandising, Conrad maintained a nearly Churchillian composure in the face of juvenile male behavior and back-stabbing female frenemies. Her constant disappointments in love and her ability to eschew various Hollywood rites of passage—Asian symbol tattoos, collagen lip injections—made her a favored cover girl of women's magazines and a good-girl role model. "She was always going through that relationship saga of trying to find the right guy," says Adam DiVello, creator and executive producer of *The Hills*. "It was very Carrie Bradshaw."

All along, Conrad's ambition was to leverage her exposure into a miniature lifestyle empire. By 2009, *The Hills* had become MTV's most successful show, with *Sopranos*-esque DVD sales of 2 million, a thriving mobile streaming content business, and a deal with iTunes. MTV also initiated a reverse product-placement scheme in which it offered clothes—similar to the styles Conrad wore on the show—for sale on its SeenON!MTV e-commerce site. That year the site produced $20 million for the network.

Conrad, who made $75,000 an episode, as first reported in *In Touch Weekly*, says she didn't get a penny of the ancillary revenue and left the show after the 2009 season. She says she also felt restricted by DiVello's decision to edit out the ways in which her rising stardom affected her life. And that, she says, "was a dealbreaker." As a result, her new series will function as a "weekly 30-minute commercial," she says, for the LC brand. To ensure this, Conrad is an executive producer, hoping to capitalize, as Stubblefield puts it, on "more potential upside."

She's also putting her own capital at risk. Conrad has invested "a large amount" in Paper Crown, she says, to retain complete creative control. "This is mine to lose," she says. "I've learned that when you are not your own boss, you always have to meet in the middle." As a designer, Conrad says, she's often reminded that Kohl's target customer exists in, as she puts it, the "broader market." When she was designing the Lauren Conrad Collection, "I didn't always have the final say," she admits, "because someone else was financing it." Perhaps as a result, *The New Yorker* referred to one of her collections as "sub-Old Navy."

"I would love to become a big, natural brand," Conrad says

Conrad describes Paper Crown, which launches this year, as "more upstairs" than her previous work. With pieces ranging from $65 to a $390 chiffon wrap dress, Conrad says she's trying to design "very chic, clean pieces that have good fit and good fabrics" to be sold at upscale boutiques. Will consumers shell out nearly $400 for a dress designed by a hopeful soon-to-be-erstwhile reality star? "I'm afraid of failure, always," says Conrad. "There's been many, many times I questioned myself." That said, given the strength of the LC brand, she hopes to see revenue from Paper Crown in about a year.

Conrad's longer-term goal, she says, is to create "my own business in replacement of the partnerships I have." It will be, she predicts, a retail fiefdom encompassing books, clothes, and beauty products. As she ticks them off, the young mogul pauses, having momentarily forgotten something. "Oh yeah," she says, "and a TV show." At least for now. B

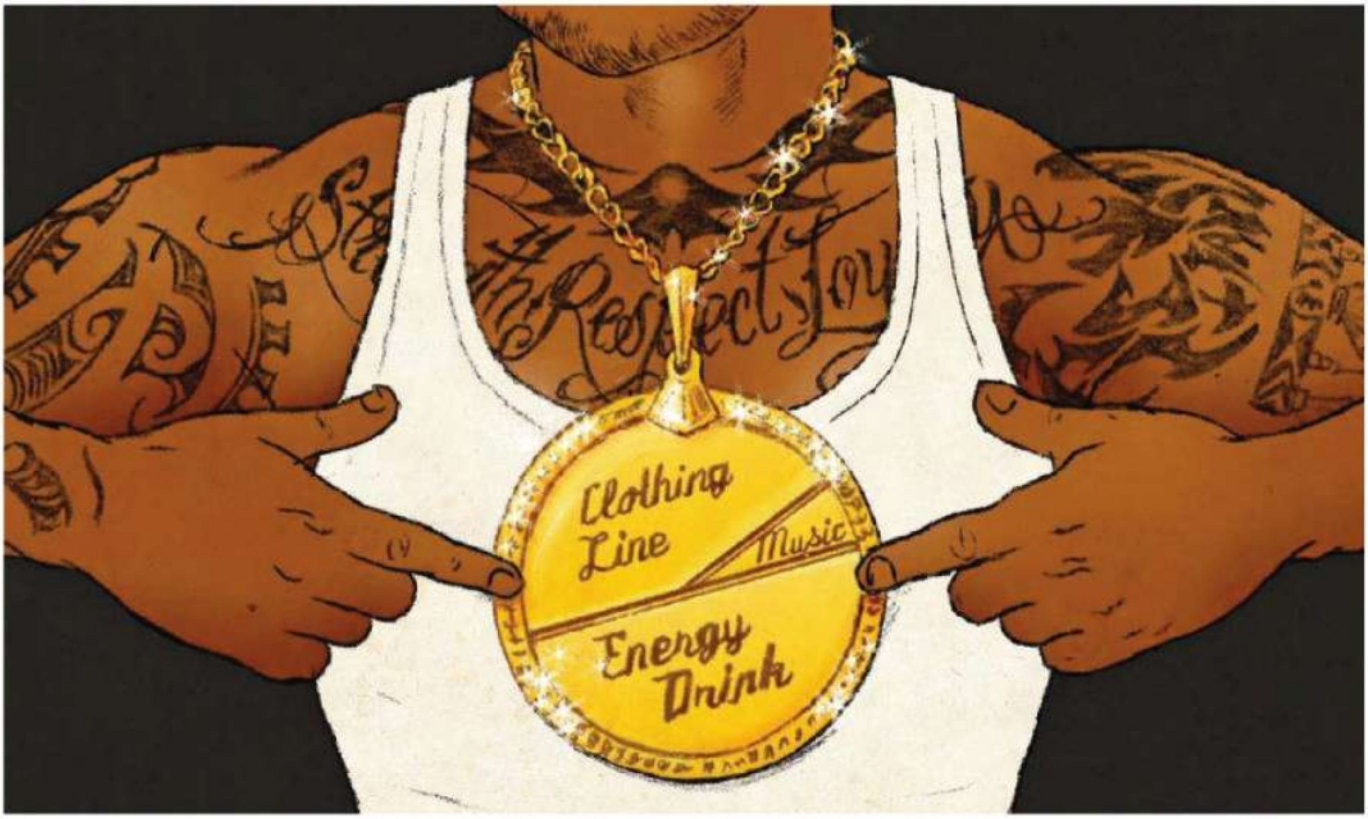
The LC Universe

How being famous for being famous can actually make you famous—not to mention rich. —*Adrienne Gaffney*



OPPOSITE PAGE: PHOTOGRAPH BY SAM COMEN FOR BLOOMBERG BUSINESSWEEK; THIS PAGE: MODEL: FRAZER HARRISON/GETTY IMAGES; CONRAD: NEILSON BARNARD/GETTY IMAGES; MOVIE: EVERETT COLLECTION;

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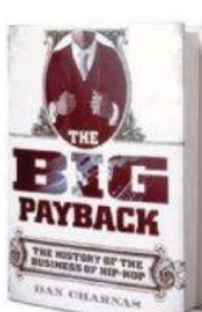
Too Bling to Fail

How to succeed in the hip-hop industry without really making music. *By Steven Daly*

After the end of the 2000 fiscal year, Loud Records co-owner Rich Isaacson discussed his label's finances over lunch with Mel Ilberman, the chairman of its parent company, Sony Music International. Although the previous 12 months had seen Loud artists such as Wu-Tang Clan, Big Pun, and Xzibit haul in gold and platinum albums, an exasperated Ilberman confronted Isaacson: Never before had he seen a company spend $100 million without making any money.

Isaacson, understandably, was taken aback. This was, after all, how Loud operated: The company had recently lavished $1 million on a promotional video for a single Mobb Deep track. Surely Sony must have known that the label and its previous partner, Bertelsmann Music Group, had parted due to years of inadequate profit margins? Apparently not. Sony shuttered Loud shortly thereafter.

The Big Payback: The History of the Business of Hip-Hop
by Dan Charnas
NEW AMERICAN LIBRARY
672pp, $24.95



This episode, described in Dan Charnas' *The Big Payback: The History of the Business of Hip-Hop*, typifies the music business in general and hip-hop in particular. This new genre wasn't exactly built on solid financial ground. The first successful rap record, Sugarhill Gang's 1979 *Rapper's Delight*, was facilitated by a $5,000 loan from Morris "Mo" Levy, a grizzled music business veteran with close ties to the Gambino crime family. Yet over the intervening decades, hip-hop invaded the suburban zeitgeist and launched its own full-blown ancillary industry replete with clothing lines, fragrances, liquors, travel agencies, and antique-looking chalices known as "pimp cups."

Is there financial wisdom to be gleaned from this multibillion-dollar enterprise? Perhaps. Charnas, a former talent scout and a writer for *The Source* magazine, has written a book that presents itself as a business manual of sorts, "focusing on successful marketing strategies" and providing a "primer on hip-hop's bold and compelling paradigm for business success." Unfortunately, as Charnas reveals in his 600-page-plus tome, the paradigm was actually based on the old business practice of winging it, then cashing out.

During its three tumultuous decades, hip-hop's top executives often appeared to be improvising as

adroitly as their platinum-certified rappers. For years the so-called rap game was a virtual gold rush that attracted all manner of colorful entrepreneurs and left countless artists nursing serious financial grievances. The moguls who came to dominate the industry in the mid-'90s—Sean "Diddy" Combs, Russell Simmons, and Damon Dash—were all gifted self-promoters who, as portrayed in *The Big Payback*, were more or less extemporizing in a marketplace created by a young, capricious demographic.

This formula didn't guarantee big bucks for record companies. In the early '90s, Charnas writes, Sony was exasperated at the "endemic disorganization" through which its Def Jam imprint, under Simmons' stewardship, had accrued some $17 million in debt. If only they'd realized that record sales were becoming a secondary revenue stream. With the creation of the clothing line Phat Farm in 1992, Simmons became the first rap entrepreneur to look beyond mere music and attempt to market the ghetto-quixotic lifestyle preached in hip-hop's lyrics. Five years after he and his partner Lyor Cohen had unloaded their stakes in Def Jam for $135 million, Simmons cashed out of Phat Farm, in 2004, for nearly $140 million.

The message hidden within *The Big Payback* is that while hip-hop may be a volatile industry, few of its business strategies are unique. After Simmons' initial success, virtually every major rap figure tried to establish a presence in the rag trade. Combs' Sean John label and Jay-Z's Rocawear line were among the most prominent companies to follow in Simmons' footsteps. (Combs recently signed an exclusive distribution deal with Macy's, while Rocawear was sold for $219 million in 2007.) Rapper 50 Cent also launched a successful clothing line, G-Unit, before entering a 2004 partnership with Vitamin Water parent company Glacéau. 50 Cent's unimpeachable street credibility—he was shot nine times at close range in 2000—helped sell millions of bottles of his signature drink, Formula 50. In 2007, Coca-Cola purchased Glacéau for $4.1 billion, and "Fitty" walked away with, Charnas writes, upwards of $60 million.

Of course, others weren't as lucky. Jay-Z's former wingman Damon Dash steered Roc-A-Fella Records on a self-immolating expansion drive that included magazines, movies, and a vodka brand. Despite Dash declaring himself the Tiger Woods of business, banks foreclosed on his two New York condos in 2009.

While *The Big Payback* is no business primer, it does contain hope for aspiring music moguls. Despite record sales' free fall, most of hip-hop's ruling class is enjoying some well-earned rest after making millions on all the lifestyle extensions they launched. Looking on the bright side, there's now ample room for a new cohort of inventive mavericks to take over. Ⓑ

The Rap Mogul Totem Pole

A hierarchy of the hip-hop business' biggest players and pretenders—some of whom still even make music.



Players

Jay-Z
As he rapped: "I'm a business, man." He ran Def Jam Recordings, then left in 2007 for a $150 million deal with music juggernaut Live Nation.

Russell Simmons
The ambassador of the hip-hop "lifestyle" sold his major assets, Def Jam and Phat Farm, for nine figures. He's now known for philanthropic works.

Dr. Dre
Since his first solo album, in 1992, he has become a multi-platinum producer who promotes Dr Pepper and his line of high-end headphones.

Sean "Diddy" Combs
Despite an inability to settle on a moniker, his cultural equity remains high enough to earn lucrative endorsements, like one with Cîron vodka.

Chris Lighty
The Violator Records & Management founder ran 50 Cent's comeback and, in 2004, engineered the rapper's deal with mineral water company Glacéau.

Master P
The ex-Continental Basketball Assn. player ushered in hip-hop's "Dirty South" era in 1996 with his first platinum album, for his No Limits Records.

Irv Gotti
His Murder Inc. label had its name diminished to The Inc Records after Gotti was acquitted in 2003 on money laundering charges.

Damon Dash
Before going into free fall in 2004, the Roc-A-Fella Records mogul hired a videographer to shoot his daily routine. He now runs a modest Manhattan art gallery.

Pretenders

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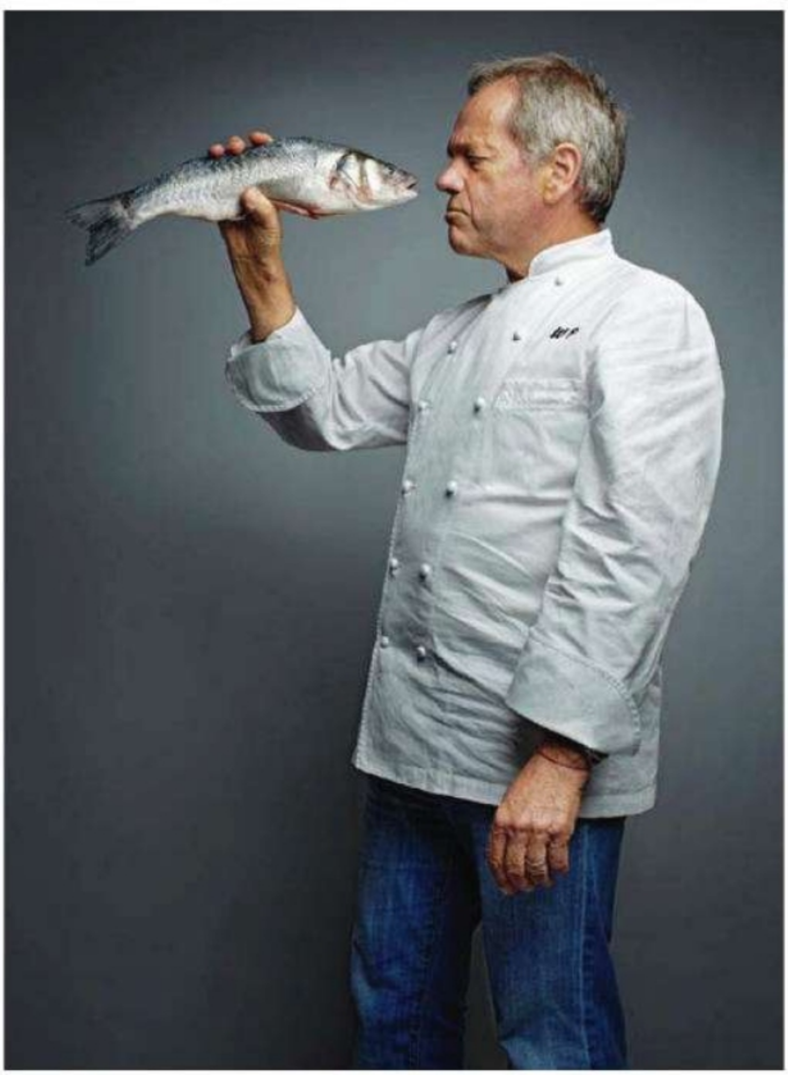
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Etc. Hard Choices

Wolfgang Puck

"I had previously tried a line of frozen desserts that hadn't worked ... but if Johnny Carson liked my pizzas frozen, maybe others would"

The chef-entrepreneur on entering the kitchen at 14 and defying the foodie world with Spago–and his frozen pizza empire



PHOTOGRAPH BY MIKE MCGREGOR FOR BLOOMBERG BUSINESSWEEK

I left home at 14 to be a kitchen apprentice and spent most of my early career in some of France's best restaurants. If you wanted to be a respected chef, that was the best training you could have. By the 1970s, when I was at Ma Maison [a French bistro in Los Angeles], I decided to open my own restaurant. The easy choice would have been to open a French restaurant, but I decided on a pizzeria called Spago. I thought you could have fun with the ingredients and create delicious simple food, but newspapers ridiculed me, saying you couldn't create a gourmet experience around pizza. The editor-in-chief of *Bon Appétit* even took me to dinner to try to convince me not to open it. I had my own ideas, and it became a huge success.

I never thought about selling frozen pizza until Johnny Carson became a customer. I was preaching fresh food all the way, but Johnny would take home 10 or 12 pizzas at a time. One day, I finally said, "Johnny, what are you doing with all these pizzas?" He said, "I put them in the freezer and pull them out when we're playing cards. They're just as good." I thought he was crazy–and I had previously tried a line of frozen desserts that hadn't worked out so well. I was nervous, but if Johnny Carson liked my pizzas frozen, maybe others would, too. I went home to try it myself; I thought he was right.

It wasn't so easy, though. Duck sausage pizza was our most popular at the time. When I did a focus group, everyone said "Ewww. I would never buy a frozen pizza with duck." So I had to make the line more pedestrian–vegetarian and spicy chicken, a combination of cheeses. There were also some things you just couldn't do. My favorite was prosciutto pizza, but it doesn't freeze well. Our most popular pizza at Spago is the smoked salmon pizza, but you can't freeze that, either. And, of course, if people don't cook it the right way, the pizza won't taste as good. In a restaurant, you have much more control.

As my business has grown, the hardest thing has been to give up control. It might make people think I'm arrogant, but I'm not. This is my name. This is my life. B —*As told to Diane Brady*

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